Cash Management Techniques

This article looks at the latest cash management techniques that treasurers should be aware of in terms of netting, pooling and cash concentration.

The role of finance and treasury in sustaining and creating value is changing substantially. The traditional guardianship and risk management roles of finance and treasury are being continually revised. At the same time, finance is being asked to become more effective and efficient in supporting core needs across the enterprise.

In terms of cash management, this means enabling a continuous and accurate reporting of the cash position, providing responsive forecasting data and handling payment transactions more efficiently, as well as managing and evaluating financial risks with greater precision.

Current Trends and Developments

In the context of cash management, there is an increased convergence of cash, liquidity, risk and trade management. Therefore, cash management is not only related to ensuring solvency and handling of payment transactions, but also involves risk management and working capital management alongside the entire financial supply chain (purchase-to-pay, order-to-cash, etc).

Furthermore, efficient cash management is expected to significantly improve both the profitability and growth of a company. As a result of globalisation and the competitive environment, companies are seeking more sophisticated cash management solutions and focusing on standardised processes and strengthening internal controls, which will lead to a higher degree of centralisation of cash management activities. The ongoing centralisation of corporate cash management activities is no longer restricted to larger corporates but is also on the agenda of small and mid-sized companies.

Research, conducted by the IBM Institute for Business Value, in co-operation with the Wharton School and the Economist Intelligence Unit, confirmed the trend of transition from decentralised to centralised cash management functionalities on a global - or at least regional - level among more than 1,200 CFOs and senior finance professionals.

The research also found that the most successful finance organisations have an enterprise-wide common data definition, a standard chart of accounts, standard common processes and globally mandated standards. By adopting enterprise-wide processes and data standards, finance organisations can start to simplify enabling systems and delivery models and establish governance to create an integrated finance organisation for greater efficiency. The criteria for developing an integrated finance organisation will also have an impact on organisational cash management structures (shared service centres, payment factories, in-house banks, etc), as well as on IT developments.

The introduction of the single euro payments area (SEPA) has also encouraged the trend towards centralised cash management activities on a pan-European level, e.g. through payments factories, even if the SEPA Credit Transfers (SCT) volumes remain marginal and are currently behind market expectations. This development will happen gradually as there is a long transition period where SEPA formats and domestic formats will exist in parallel. Plus, not all local payment instruments are within the scope of the SEPA initiative.
Traditional Cash Management Elements

Figure 1: Elements of Cash Management

- **Cash Management consists of 5 main tasks:**
  - Cash Pooling
  - Liquidity Planning and Forecast
  - Handling and Optimisation of Payment Transactions
  - Refinancing, Financial Assets
  - Bank Relationship Management

**Definition of Cash Pooling**
- Group individual, automated cash compensation measures
- Resulting in reduced external liquidity needs with lower financing costs

**Targets of Cash Pooling**
1. Centralisation of Group liquidity
2. Efficient fund raising
3. Improvement of interest result
4. Increase in level of automation

**Cash Pool Techniques**
1. Cash Concentration (physical transfer of liquidity)
2. Notional Pooling (interest compensation)

*Liquidity planning and forecasting*

The ongoing liquidity squeeze and impact of the credit crunch have resulted in corporates intensifying their liquidity management efforts, effectively making liquidity management a high priority. Therefore, many companies are seeking an appropriate approach to improve their liquidity management, especially by means of improving adequate liquidity forecasting models. Due to improvements in IT and advances in forecasting techniques, an increasing number of companies are beginning to rely on professional treasury information systems instead of using manual spreadsheets.

A short-term liquidity plan and medium-/long-term liquidity forecasts are closely linked and follow in a timely sequence. Corporates should aim for an automated and integrated IT solution that supports the entire liquidity planning and forecasting process.

Liquidity planning and forecasting also requires the evaluation of a corporate's banking relationships and account structures in order to achieve efficient liquidity management. The implementation of a payments factory and an in-house bank also aids efficiency and, in addition, can provide meaningful financial reporting.
Finally, efficient liquidity management also affects the effectiveness of risk management. The higher the accuracy of liquidity forecast, the more stringent risk management procedures can be developed.

**Handling and optimisation of payment transactions**

The introduction of SCT at the beginning of 2008 was an important step to harmonise the handling of payment transactions within Europe and to reduce cross-border charges for corporates. SEPA has the potential to accelerate a corporate’s efforts to move its payments to a central payments factory in order to create a cost effective and secure technical infrastructure with the possibility of enabling appropriate banking communication and simplifying corporate-to-bank-connectivity (e.g. via SWIFT's Standardised Corporate Environment (SCORE) or direct access to banks). SCORE is a participation model developed to connect corporate participants, which are listed on a regulated stock exchange, to finance organisations. Even if the benefits of SCORE, such as single access and enhanced security, are evident, it is not necessarily an appropriate solution for all corporates; many corporates are seeking other solutions enabling direct access to banks.

**Refinancing and financial assets**

A greater number of companies prefer centralised refunding of their capital requirements. This leads to an optimised refunding in terms of volume, diversification possibilities, refinancing/interest costs and improved results of external ratings. In addition, centralised refunding management can lead to a reduced administration workload and increased transparency regarding financial assets.

**Bank relationship management**

Corporates should not just re-evaluate their banking relationships because of SEPA, but also in the context of an increased number of bank mergers. International corporates are advised to establish professional bank relationship management procedures. Advanced bank relationship management is not restricted to a secure and auditable banking structure that can be efficiently administered, but also includes some risk management components in order to indicate potential risks prevailing with banking partners. Furthermore, efficient bank relationship management should support business relations to individual banks in order to avoid a liquidity squeeze in the case of mergers or a banking crisis.

**Recent Cash Management Elements**

As mentioned before, many corporates are moving their payments to centralised payments factories to realise economies of scale and handle their payments more effectively. The potential benefits derived from centralising the accounts payable process are the main driver for corporates to establish a payments factory that provides a centralised platform for straight-through processing (STP) of payments and streamlines the entire payment process.

In addition to the establishment of a payment factory, many corporates are also thinking about centralising their accounts receivables management. Centralised collection management can be very helpful, particularly for companies with a large volume of direct debits.

A combined approach of centralising, not only the accounts payables but also the accounts receivables management, will bring out further synergies, e.g. greater accuracy in evaluating the current cash position and future liquidity forecast, thus enabling a comprehensive cash management function that will streamline all transaction processes and bank communications.
Important Challenges for Treasurers in Relation to Cash Management

As a result of the aforementioned developments in the cash management area, there is growing demand for cash pooling solutions. Cash pooling is still a complex technique for many corporates, considering different legal and tax regulations across Europe. Depending on the country, there are still some barriers hindering the free movement of funds. The introduction of SEPA will intensify corporates’ need to implement appropriate cash pooling structures. SEPA, of course, also has an impact on streamlining the number of bank accounts across SEPA countries.

Cash pools are often managed and controlled by the corporate treasury or finance department. Typically standard processes are implemented, a high level of automation exists and, depending on the volume, cash pooling is integrated into the internal payments factory and in-house bank.

Implementation steps

During the implementation or optimisation of a cash pooling structure, companies have to consider several internal and external aspects:

1. Company-internal aspects: company strategy (e.g. expansion-orientated), inter/national organisation or structure, internal policy in respect of capital, dividend and inter-company loans, and bank relationship management strategy.

2. External aspects: several legal and tax requirements (e.g. arm’s length principle), bank services, costs, foreign exchange risks, inter/national cash pooling specifications, regulatory reporting, and national capital controls.

Figure 2: Implementation Steps

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<tr>
<th>Implementation Steps</th>
<th>Comments</th>
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<td>1. evaluation of the current situation</td>
<td>group-wide data analysis, e.g. banking structure, current cash management techniques of all participating companies, cost-benefit analysis</td>
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<td>2. analysis of possible internal policies (refinancing)</td>
<td>capital increase (thin-cap), distribution of dividends, intercompany loans, existing terms of payment</td>
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<tr>
<td>3. consideration of external requirements</td>
<td>bank selection/competence, review of tax and legal aspects, regulatory reporting, national capital controls</td>
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<td>4. documentation and legal contracts</td>
<td>cash pooling contracts, intra-group funding agreements (arm’s-length principle) incl. fixing of amount limits and interest rate</td>
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<td>5. going live</td>
<td>daily co-ordinated involvement into the group-wide cash management function, integration into payment factory and in-house bank if reasonable</td>
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Source: IBM
Cash pooling techniques

In general, cash pooling allows companies to combine their credit and debit positions from various accounts into one account. Cash pooling involves various techniques such as cash concentration (zero balancing) and notional pooling, which are also, according to our experiences, the most common cash pooling techniques.

a) Cash concentration

Cash concentration is an automatic transfer of account balances from clearly defined sub-accounts to a cash pool master account on a value date basis. Cash pooling can be structured domestically or cross border depending on the corporate structure. There could be several individual specifications for the sub-accounts, for example minimum balance held on the account, minimum amount for transfer or fixed days for regular money transfer. In case of zero balancing, the account balances of the sub-accounts will have a zero balance and the liquidity position will be available on the cash pool master account.

Target balancing is similar to zero balancing except that the target balance, as a minimum level of liquidity, will remain available on the participating sub-accounts. Target balancing is often used to avoid difficult and more expensive credit line issues, or because of local regulations.

b) Notional pooling or interest compensation

Notional pooling has the same aim as zero balancing except that there is no physical transfer of liquidity from the sub-accounts to a cash pool master account. All participating accounts are only combined virtually for the purpose of interest or charge calculation, whereby balances are automatically offset, thus reducing the difference between high interest on debit balances and low interest on credit balances.

The accrued interest is paid on the net balance position and the results are compensated. Therefore, notional pooling can also be called interest compensation.

The accrued interest can either be posted to one of the involved bank accounts or to a separate interest account. Depending on individual agreements, the accrued interest is usually allocated back to each of the sub-accounts of the involved subsidiaries in proportion to its contribution to the process of offsetting.

Regional Aspects

The implementation of efficient cash pooling structures differs from region to region. Furthermore, a single currency pooling structure can be much easier implemented compared to a multi-currency pooling. Taking a closer look at Europe and Asia/Far East, the situation can be summarised according to our experiences as follows:

National cash pooling structures

The implementation of a national cash pool, e.g. in Germany, does not create a great challenge at the present time.

European pooling structures
After the introduction of the euro in 1999 and as a result of the SEPA initiative, the forced harmonisation of tax and legal requirements is at an advanced stage. Therefore, pan-European cash pooling structures could be implemented, in most cases, very efficiently. In central/eastern Europe there are still some hurdles but the development of the cash pooling services in this region is strongly promoted by Austrian banks. In several countries cash pooling can be realised, for example the Czech Republic, Hungary, Poland, Slovakia, etc. Nevertheless, the feasibility of each cash pooling initiative needs to be analysed case by case.

Asia/Far East cash pooling
To date, in most cases, it is a challenge to integrate companies in Asia/Far East into a corporate's cash pooling structure. Comprehensive tax and legal requirements, as well as prevailing capital controls and inherent foreign exchange rate risks, often prevent these companies from participating in cash pooling. In Asia, business is still local and regulated, which puts restrictions on what corporates can do. Yet, on the other hand, things are beginning to change very rapidly.

Cash Management Technology and Infrastructure
The consistent realisation of cash management techniques requires adequate business processes and technologies. The characteristics of an integrated finance organisation, such as common data definitions and globally mandated standards, can also help to establish a global treasury platform, consolidating various cash management and payment transaction applications and centralising all cash management activities.

The implementation of a global treasury platform, for example based on SAP, covers all cash management related business processes and functionalities (cash management, in-house banking, banking communication management and liquidity planning) and leads to:

- Increased efficiency and transparency along the entire financial supply chain through STP and standardisation.
- Accelerated cash reporting and payment processes resulting from in-house banking and payments factory structures.
- Streamlined transaction processes and banking communication across the group of companies leading to cost savings and an optimised interest management.
- Increased data consistency, integrity and reliability in terms of the cash position and liquidity forecast as a consequence of the harmonised infrastructure and business processes.
- Improved exposure management by providing treasury with accurate and timely cash flow and exposure information.
- Increased data integration, and therefore automation, regarding the collection of forecast and transactional data.
- Decreased organisational complexity and process duplication resulting from standardised and automated business processes.
- Reduced legacy systems and interfaces generating cost savings in the areas of purchasing, licensing, maintenance and development.
• Improved internal controls that are consistent across the globe and compliant with external regulations.

Conclusion

The comprehensive changes in the cash management area resulting from globalisation and ongoing centralisation, as well as the increased use of more advanced cash management techniques, have a strong impact on the definition and role of the corporate finance and treasury department. Furthermore, cash management activities are expected to achieve a positive value proposition.

Cash management activities cannot be considered segregated from other financial processes but should be integrated into the financial supply chain. This leads to an integrated finance organisation that also has an impact on organisational cash management structures, e.g. shared service centres, payments factories, in-house banks, collection centres, etc, and requires more standardised and integrated business processes as well as appropriate IT solutions.

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