Subsidiaries are the key to success

With the introduction of the euro, corporates are reviewing cash management strategies. Chris Hill and Charles Barlow of Arthur Andersen explain.

For many corporates, the introduction of the euro has provided the impetus to review liquidity management strategies to achieve the benefits and savings available in the new order. This will normally involve treasury in the management of subsidiary companies' cash surpluses and the central, rather than local, provision of debt. These are often highly emotive issues for operationally independent subsidiaries and, in our experience, the key to the successful implementation of a cash management solution lies in 'selling' the benefits to the participants at the outset of the project.

This article outlines the quantitative and qualitative benefits of cash management for the group as a whole and the subsidiaries involved, and discusses the process that corporates need to follow to secure them.

Group savings

The most obvious savings arise from the reduction in interest expense and the increase in interest income from the regular offset of surplus and deficit bank account balances. The size of these savings will be dictated by the liquidity profile of the group, the credit rating of individual subsidiaries, and the extent of their current treasury management activity. The savings arise because the treasury centre, acting as an 'in-house' bank, is able to save the spread between the bank's deposit and borrowing rates and distribute it between the group and its subsidiaries.

Recycling cash in the group will usually lead to a reduction in external bank debt, an improvement in gearing and correspondingly a reduction in facility fees. Thus, the use of excess liquidity in the group also allows the corporate to review overall financing requirements.

> Standardisation gives management a simple group-wide view of cash – an essential component of shareholder value which few corporates have

The establishment of an efficient cash management structure can be used as the means to distribute the proceeds of a centrally arranged short-term working capital facility, such as a commercial paper programme. This effectively enables group subsidiaries to finance their operation at a much finer rate than their own balance sheet and access to the capital markets would allow. Within group guidelines, subsidiaries can draw down and repay funds as required providing them with the flexibility to cover variances to expected cashflow.

Group benefits

Implementation of a cash management structure emphasises the need to manage cash actively at both operating company and group level. An efficient cash forecasting process is key to the successful use of the structure. The treasurer or cash manager needs to identify what liquidity is available or needed, when and for how long.

The implementation of a project also provides the treasurer with an opportunity to improve existing processes. He or she should easily be able to demonstrate the savings that will accrue to the group and operating companies from the provision of timely and accurate cashflow information.

The standardisation of liquidity forecasting and reporting processes enhances control and provides management with a simple group-wide view of cash – an essential component of

Chris Hill

Charles Barlow

shareholder value and something that few corporates truly have.

Subsidiaries' savings
In reply to the subsidiaries' question: "What's in it for me?", the answer is: increased income on the surplus balances and reduced interest costs on debt.

Some treasuries do not force subsidiaries to use their services; a mere comparison of the rates between local bank and treasury is often enough to encourage them to pool liquidity.

The implementation of a structure often results in the closure of unnecessary bank accounts and the negotiation of banking arrangements at group level. Savings arise from:

- the reduction in bank account maintenance costs;
- the reduction in bank transaction fees; and
- an end to unnecessary value dating. and lifting charges.

A central cash management solution provides an efficient platform for the execution of many inter-group and third-party transactions. Intercompany trade settlements and finance transactions can be made via the central pool, at reduced or nil cost.

Third-party disbursements and possibly collections can also be made through the pool. If the volumes support it, mechanisms can be installed to make all cross-border bank payments as domestic transactions.

Subsidiaries' benefits
Having by now convinced subsidiaries of the altruistic and indigenous value of the pool structure, the next question to tackle is: "How many more people will I have to employ to operate this?". The simple response is, none, if you are already proactively managing cash. The only difference is that the in-house structure is now the counterparty for deposit-taking and borrowing rather than the local financial institutions.

The efficient operation of the cash management structure is often supported by additional systems; bank workstations for balance reporting and possibly treasury modules to assist in forecasting. The design and development of standardised processes and reporting formats with group level input and subsidiary participation can assist local management in developing management tools that actually save them time and allow them to get on with the job of running their businesses. The total time spent on day-to-day banking activity may well be reduced!

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Cash management structure
Corporates will need a cash management structure to suit their liquidity profile. To work out its structure, the first step is to get a breakdown of all bank accounts and their uses along with average balances. The second step is to understand the nature of cash flows between third-party and intercompany, domestic and cross-border, electronic and paper transactions.

Access to this information enables the treasurer to determine currencies to be pooled, the frequency of pooling, how pooling will affect the liquidity profile and funding requirements, and how the pool might be used efficently to make further savings.

Factors determining the structure
Now the treasurer has identified and understood the potential savings and benefits, he or she can start to review the type of structure required to achieve them. Consideration of a number of factors will help in this decision:

Ownership of funds – some corporates insist on keeping ownership of their funds, often prompted by legal requirements.
Cross-guarantees – may not be acceptable for subsidiaries in some countries due to regulatory/legal issues.
Visibility of funds – some corporates have this high on their list of priorities while it will not be an issue for others.
Administrative and accounting work – contract confirmations and additional accounting entries can be a burden for those treasuries not used to intercompany loans.
Group funding – funding of participants should influence the structure eventually chosen.
Location – location of the treasury vehicle will affect the method and ease of operation of the pools.
Tax considerations – tax can be a critical factor in a cash management solution and a thorough tax review of the structure and scheme is vital. The implications are dependent on the nature of the arrangement, ie zero balancing, notional pooling or a combination of the two methods, and the nature of the service that is offered by the selected bank. As a minimum the following should be addressed:

- the characterisation of interest will differ between zero balancing and pooling for identification of any withholding tax, thin capitalisation and transfer pricing issues;
- a detailed review of these and other tax issues on a country by country basis is required to identify specific tax pitfalls and devise solutions to the company's circumstances, in the process selecting the most tax-efficient structure; and
- a review of each tendering bank's standard pooling documentation at an early stage can highlight differences between their written proposals and the mechanics of pooling arrangements in practice.

Cash management requirements
It is important to establish a company's cash management requirements and the criteria that matter to it in the provision of a cash management solution. These criteria should be weighted according to their importance and this task should be completed before the bank selection process takes place.

This will allow the treasurer to identify how the bank's preferred solution fits the company's requirements, not the other way round.

Bank selection
The second key decision is the choice of bank. Many companies prepare a request for proposal setting out their

requirements, along with some of the data gathered at the outset. This allows the banks to focus their approach and tailor their solutions.

The banks' responses need to be studied and analysed at length and the solutions compared before a series of meetings to learn more. These meetings are an opportunity to ask questions focused on those areas that are important to the structure.

The bank's offerings should then be ranked and compared, and we have found this to be typically dependent on the following criteria:

Existing relationship with the group – the cash management business is prime business for the bank and a key component of the relationship they seek. Banks maintain that they do not earn a great sum on the structure itself, more from the additional transaction-based services that they hope to provide. During the proposal process it is often possible to distinguish between those banks that are prepared to be flexible and tailor any structure to meet the individual needs of their clients or who provide innovative solutions, and those that would prefer their clients to adopt the bank's standard offering.

Strategic investment in cash management products – it is far more desirable to give the business to a bank that has positioned itself to deliver cash management solutions as a key strategic offering, which is demonstrated by a significant investment in developed products and/or infrastructure and systems, than to an institution with no ability to provide an efficient service.

How well the product is established – recent regulatory changes have swung the pendulum away from notional pooling and towards zero balancing type structures. Banks have responded to this by developing hybrid account structures that involve elements of pooling and zero balancing.

Service levels – post-sales support is crucial in addition to value dating, cut-off and other efficiency issues. Many banks have invested in support centres. The best way to assess this is actively to follow up on bank references.

Ability to provide other banking services – as discussed earlier, the establishment of the structure is the first step in developing the corporate's liquidity management strategy and lays the foundations for accessing a number of additional bank services to add greater efficiencies.

Costs – these are fundamental to the project and the tariff structure needs to be thoroughly understood and compared. However we would suggest that, in our experience, cost is rarely the deciding factor. It is far better to pay a little more for a proven reliable service.

Reference visits – although a bank is unlikely to provide you with a reference that will not support its product it is useful to take up references. An hour's time with a fellow treasurer who has current experience of the solution you are being offered can be valuable.

Implementation

Although not the main purpose of this article, it would be incorrect to finish with the selection of the bank. Successful implementation requires sponsorship of the project by senior management to ensure that all those involved actively participate in the process.

It should be recognised that this is not just a cash management project that involves deal execution by central treasury but a business partnership that requires treasury to become actively involved in the subsidiary's business.

Implementation can be extremely challenging. It requires a project manager with authority and drive who must:

- define objectives;
- set realistic completion dates;
- assign responsibilities;
- obtain dedicated resources; and
- set agreed performance measures.

The end of stage one

The selection of the cash management bank is the selection of a long-term partner.

You must be able to work with the bank through the selection process, the often difficult, frustrating and time-consuming implementation process and, finally, you have to work together for a long time after – or at least until you re-tender for a new partner. ■

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Profile

Andrew W Reid
Vice President
Credit Suisse First Boston

Age: 32

Education and Qualifications:

1980–5	Aldenham School, Herts
1986-9	University of Exeter
1992	Chartered Accountant (ACA)
1995	AMCT*
1996	MCT*

Career history:

1989 Touche Ross & Co, London (now Deloitte & Touche) – Trainee Chartered Accountant, then Audit Supervisor, Financial Institutions Group

1993 Standard Chartered Bank, London then Singapore – Asset Liability Management Analyst, then Product Accountant, Treasury and Investment Banking. Transferred to Singapore in 1995 to support increased Investment Banking trading activity

1997 Barclays Capital, Singapore – Product & Operations Controller for trading activities in Singapore.

1998 Credit Suisse First Boston, Zurich then London – Product Controller focusing on interest allocation across the business activities. Transferred to the London Corporate Treasury department in October 1999.

"I went into treasury as a profession to build on my accountancy training and make myself more marketable in the pool of recently qualified ACAs. The ACT qualification was particularly relevant to the asset and liability management role that I held at the time and was attractive because of its flexibility – across the financial sector, in industry or in the profession.

I completed the AMCT course in 1995 and the MCT course in 1996, the latter while living in Singapore. I have spent the past three years in financial and product control in Singapore and Zurich with an emphasis on foreign exchange, funding and interest allocation as well as revenue analysis for fixed income and derivative trading activities. I recently transferred to CSFB's corporate treasury department in London and now have the opportunity to put some of the more detailed aspects of the MCT syllabus into practice."