Cash Management as the most Important Part of Corporate Treasury  

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Abstract

This paper focuses on cash management, particularly on cash pooling and netting, which is one of the most extended treasury department areas in the Czech Republic, as with most countries around the world. The objectives of cash management are straightforward – maximise liquidity and control cash flows and maximise the value of funds while minimising the cost of funds. Cash pooling as an important part of cash management is a bank product that enables a group to collect money and use it for either further investment or lending. The product is available to companies, which are part of a group of economically related parties. Cash pooling has very quickly become a part of the Czech corporation’s consciousness. Beside domestic notional and zero balancing cash pooling, Czech banks now offer cross-border pooling, both notional and real, for accounts in certain currencies.

Key words
Cash management, cash pooling, netting, treasury, treasury centre

1 INTRODUCTION

The objectives of cash management are straightforward – maximise liquidity and control cash flows and maximise the value of funds while minimising the cost of funds. The strategies for meeting such objectives include varying degrees of long-term planning requirements. Also, like everywhere in the world, much treasury activity in the Czech Republic is concentrated on cash management. This includes financing the corporation, administration of debts (loans, bonds, commercial papers, etc.), good relationships with the banks, payments to suppliers and collections from customers, control of foreign currency and interest positions according to the company’s needs for finance, and finally the reporting and technical support of all these functions. The use of cash pooling as a global standard for concentrating cash into the main bank account of the firm, has very quickly found favour in corporates in the Czech Republic.

Globally, cash pooling is a bank product that enables a group to collect money and use it for either further investment or lending. The product is available to companies, which are part of a group of economically related parties. (We can’t use the word ‘concern’ because the Czech codes do not recognise this word in a legal sense.) Related parties are business entities that are related by share ownership. For cash pooling business, it is necessary for them to sign a collective agreement to operate a so-called major (master) bank account. Other bank accounts are settled toward this master account. There could be an overdraft agreement with a bank, but this is not possible for either a master account or the other bank accounts in the pooling system. Nevertheless, credit or debt interest rates have to be defined for all accounts. There has to be an agreed level of interest rates between the bank and the companies involved in the cash pooling system and between those each of those companies, too.

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2 TYPES OF CASH POOLING AVAILABLE

Banks in the Czech Republic generally offer the following types of cash pooling:

- real (zero-balancing) cash pooling
- fictive (notional) cash pooling
- multicurrency cash pooling
- cross-border cash pooling

2.1 Real cash pooling

Real cash pooling is based on a transfer from bank accounts to a master account, with balances on all bank accounts except the master account being zero at the end of the working day. It means this money physically ‘moves’ from the junior accounts to the master account.

2.2 Notional cash pooling

Notional or fictive – because money stays in bank accounts and the calculation of interest rates is based on fictive consolidated credit or debt bank balances. There is no money transfer between accounts of the companies involved in fictive cash pooling.

2.3 Multicurrency cash pooling

Bank accounts in different foreign currencies are swapped to one agreed currency, which is the base for the interest rate calculations.

2.4 Cross-border cash pooling

Cross-border cash pooling helps corporations avoid the bureaucracy intrinsic to transferring cash across countries and different clearing systems, as well as different legal entities and the headache associated with additional intercompany loan administration. While there is a selection of solutions in the marketplace, most of these operate on an interest enhancement basis where corporations are rewarded for servicing their liquidity thru their chosen bank, but the bank is unable to achieve balance sheet offset due to the complexity of multiple jurisdictional and regulatory barriers. Czech banks now offer cross-border pooling, both notional and real, for accounts in domestic Czech koruna, euro, US dollar, Central European currencies (such as in Slovak koruna, Hungarian forint and Polish zloty) and pound.

From our point of view, these principles are used both in the Czech Republic and in the rest of Europe, and are therefore similar; any differences are the result of the legal requirements of each country. As mentioned above, the Czech Commercial code does not recognise anything like ‘concern’ or a product like cash pooling. It is necessary to fulfil several conditions to prevent problems concerning taxation and reporting to minority shareholders. It is practically impossible to implement a cash pooling agreement between companies without a majority share. It is normal practice that a cash pooling system has to be agreed by a general meeting of the company and there is a strict requirement for signed control agreements. Sometimes it is necessary to change the company articles of incorporation.

3 EFFECTIVENESS OF THE CASH POOLING

The first possible viewpoint is a viewpoint according to the type of company where the cash pooling system is to be used. The first case is use within the scope of one company with a number of individual organizational units (plants), where pooling enables effective management of financial means even during a requirement for decentralisation of the organisational units. The second alternative is use within the scope of a holding company with independent accounting units – companies in the group. Here pooling makes management of
finances more effective from the accounting and administrative aspect from the beginning of separated units.

The second viewpoint of the use of pooling is according to the initial purpose. From this aspect it is possible to divide pooling into pooling for associating cash and into pooling for making financing more effective. The first use accents the improvement of the possibility of investing free financial means during a greater volume of these. The second alternative the possibility of use of the free resources of one unit for financing of other units without bank loan costs.

Which independent companies actually use cash pooling? These are any companies, which require that financial management of organizational units is kept separate and fully transparent. Also such companies that base their assessment on the realized cash flow of organizational units. An example would be the FMCG companies, industrial companies within individual plants or financial institutions with regional branches such as insurance companies for instance. Each such company must determine the degree of independence of its organizational units. Independence can be complete within the scope of an annual plan in the sphere of income and expenses. Or independence is limited in the sphere of expenses by a certain annual budget and in the sphere of income by the task of achieving the planned cash flow (the most usual case).

4 POOLING STRUCTURES

The used type of pooling structure is determined according to this differentiation. Within the scope of one company and one country the most effective system is zero balancing because it performs complete centralization of financial means. If the individual branches fulfil simply the income part of the budget and expenses are centralised, it is suitable to perform transfers in only one direction. Single-direction zero balancing is the system most used. With regard to the overdraft limit in this arrangement then this is not allocated on the level of individual accounts (organizational units) and usually serves only on the master account level for covering cash flow deviations. If the branches are not an income but a cost centre, it is suitable to enable either drawing of an overdraft limit from their accounts or to subsidise them by a certain sum each day. If costs are approximately the same every day it is appropriate to use dual-directional pooling with retroactive transfer of the defined amount of the daily budget. This arrangement can also be used during management of branches governing income and expenses, if expenses fulfil the requirement of stability. In this arrangement we do not allocate an overdraft limit on the level of the individual account. Management of branches issues from the determined daily budget. The overdraft limit on the main account serves for the purpose of the centre and for cases of non-coverage of expenses of a branch by income from elsewhere.

In cases of cost branches, which have variable expenses during a measure of days, but stable expenses within the scope of the month, it is possible to select from several various arrangements. One alternative is to transfer the whole volume of the monthly budget to a secondary account and monitor the volume of submitted payment orders in the centre (must be monitored by the company information centre). The second alternative is to enable the individual account to draw an overdraft of up to the sum of the monthly budget. And again the company information system must monitor either the volume of submitted payment orders (the more complicated alternative) or the volume of transfers from the top account to the secondary account. This alternative is also offered by some banks within the scope of real pooling. Their system enables automatic monitoring of the cumulative volume of transfers between the top and individual account and if the overall cumulative limit for drawing is exceeded, does not allow drawing of an additional overdraft. If the branch expenses are
various even from month to month it is possible to resolve this problem by regular modifications to the sum of the overdraft limit month by month. In these cases the overdraft limit of the main account is delegated to individual accounts and its sum does not have to exceed the sum of limits of individual accounts. It is appropriate to modify the settings of the individual overdraft limits according to the updating of the annual plan of expenses.

In the event that the organizational unit governs income and expenses a combination of the mentioned approaches is necessary. The simplest method is the alternative of profit centres, when expenses must be covered by the own income of the unit. Subsequently the most suitable solution is dual-directional pooling with retroactive transfer of the transferred balance. For better coverage of the cash flow the branch may be set an overdraft limit. If the branch has limited stable daily expenses the already mentioned alternative of retroactive transfer of the target sum is appropriate. If we wish to limit the variable expenses and the branch also has a set income, then it is appropriate to plan the acceptable negative difference within the certain period between income and expenses and to enable cumulative drawing of an overdraft for this amount during the course of the period.

All the above given types of use of pooling allow for pooling in one currency. This is the most usual type because conversion operation costs do not exist. Pooling with conversion usually also brings such great expenses that it is not worth it for larger amounts. Consequently it is better to divide organizational units so that they work with the smallest possible number of currencies (with a minimum of accounts). If they work with multiple currencies it is appropriate to again structure each currency according to the responsibility and character of income and expenses of the given branch as was mentioned above.

5 POOLING WITHIN A HOLDING STRUCTURE

Naturally international companies use cross border pooling and associate liquidity in individual currencies in their nostro accounts serviced by the central treasury of the company. Use in the case of holding companies is more complicated particularly as a result of the legal problems which exist in the Czech (domestic) environment and for reasons of greater decentralisation of information and functions than in one company. On the other hand the range of purposes for which cash pooling can be used is expanded by tax optimisation, in-group financing according to the rules dictated by the owner and not the bank and in-group risk management thanks to netting positions in individual currencies.

Cash pooling used within a holding is based in the acquired controlling share in subsidiary companies. Individual participants of the pool may have, but do not have to have, mutual financial flows. However their existence makes use of the pooling structure more effective, if mutual settlements are performed within the scope of one bank and one pooling. The central treasury may in such cases take two different standpoints.

Either it can completely omit management of in-house receivables and payables and monitor only external potions, because in-bank transfers do not change the overall position of the pool. Or the second possibility is decentralisation of settlement of in-group items, when all in-group payments are initiated by a centre. This naturally also performs potential netting of payments by means of setting off. The highest level of centralisation is arrangement of the cash flow within the scope of an in-company bank, which maintains accounts of individual companies and performs operations on the internal accounts of these companies. The whole company has a single account for external relations. This naturally minimises costs for the whole administration of current accounts and payment orders. Of course the relevant account exists for each currency and is situated in its home country so that the best conditions for domestic payment relations and the best conditions for storage of excess or drawing loans is achieved. All company accounts are placed with a single worldwide financial institution so
that the fastest possible international coverage of financial needs is possible. Of course multiple accounts may be used for some currencies if establishment of these reduces costs (see for example Single European Banking Market).

The problem of individual subsidiary companies or plants is resolved by a system of identification symbols for individual organizational components. The internal treasury system then maintains imaginary internal accounts for individual divisions or subsidiary (affiliated) companies and performs all in-company or in-group settlement simply by transfer to these imaginary accounts. Consequently a significant amount of bank fees for payment orders is saved. This concept is completely logical and truly maximally economic. On the other hand in the Czech Republic and elsewhere it encounters legislative restrictions. In the case of one company this does not yet concern such a great problem. However in the case of administration of accounts of independent subjects by an internal bank this centre has the attributes of a bank. It maintains accounts, accepts deposits, provides loans and performs spot, timed and other derivative operations. Consequently according to Czech legislation it should fulfil all the requirements of a bank including a license from ČNB (The Czech central bank). In this case it is necessary to establish or purchase a banking institution and create an in-company bank on this basis. This model is applied by some large global (Allianz insurance group) and Czech (PPF group) companies, particularly those that also provide financial services to clients.

For reasons of problems with Czech legislation the most often used pooling system within the scope of a holding is notional pooling and dual-directional balancing with retroactive transfer of the same amount. As I have already stated notional pooling enables simple compensation of credit and debit remainders and its advantage is the non-existence of any mutual loans, consequently agreement by the General Meeting or modifications to Articles of Association are not necessary. All transactions are only imaginary and in-group receivables and payables do not occur. On the other hand some banks do not wish to provide notional pooling with overdraft frames to holding companies, for reasons of the impossibility of netting of notional pool positions, which cannot be contractually determined either. The problem would occur in mortgage contracts in the state of accounts of others, which is variable. If one company drawing an overdraft limit became bankrupt, the bank could only involve this company. Even though thanks to introductions of cross defaults into contracts for loans of other companies it would be possible to partially involve other members of the holding, the bank would never be restored from the resources of other subjects (naturally with the exception of mortgage of other assets of the remaining companies, for example payables). Cross default would only mean the option of declaring financial means of other companies due payable. The second problem is the problem of bank expenses connected with holding credit remainders such as statutory minimum reserves and the fund for insuring deposits. Because in a notional pool it is not possible to net positions, the bank ‘s expenses for pooling are increased by these items. However the higher level of management is zero balancing. Thanks to the overall viewpoint of the group of holding accounts this leads to much more effective administration of money. The advantage for the bank is monitoring of only one loan exposure.

6 INTERNATIONALIZATION

International cash pooling, as has already been mentioned, is any pooling when transfer of financial means occurs over country borders. The main difference compared to standard national pooling is the need to work with nationally determined exchange rules and rules for payment relations. Furthermore it is necessary to deal with the matter of transfer quality, speed and costs between individual countries. Thanks to its complexity and the fact that it is
fairly costly international cash pooling is only worth it for greater amounts. In spite of this most international corporations use it and treasuries of international companies in the Czech Republic regularly encounter it. The most usual type of international pooling is real pooling and single-directional pooling. Controlling companies usually prefer real centralisation of resources and their re-division by means of centrally secured payment of deliveries. In-company loans, which occur within the scope of real pooling are subject to central management and settlement in international companies.

7 FINDING AN INTERNATIONAL TREASURY CENTRE

In 2005 a Master student Miss Lenka Simkova under the direct supervision of one of the authors (Petr Polak) of this article solved a case study how to find an international treasury centre for a holding company (CGS) with headquarters in the Czech Republic that has previously established cash pooling on a national basis in three currencies, three banks and three structures. It has subsidiary companies in 12 countries - in Europe (eight European Union countries + Switzerland), North (the United States) and Latin (Brazil, Mexico) America. The company wishes to expand cash pooling on an international basis and is searching for a suitable site for locating its treasury centres. The company has decided to only pool within the Eurozone. This means countries such as the United States, Brazil or Mexico can not be considered as possible solution alternatives. That means the choice where to establish the treasury centre was between the following countries: Austria, Finland, France, Germany, Ireland, Italy, Slovakia, Switzerland, and the UK. The target was to locate the treasury centre in a country that enables the best conditions for cash flow controlling and administration.

The treasury centre should be located in a tax advantageous place. The fee for maintaining an account, transaction fees and prices for foreign incoming and outgoing payments, including urgent payments, should be as low as possible. The offered yield from excesses should be as high as possible.

7.1 Setting of criterions

Criterions resulted from a target requirements are as follows:

- Bank transactions fees – to minimize
- Prices for foreign incoming and outgoing payments (including urgent payments) - to minimize
- Withholding and corporate tax - to minimize
- Withholding tax for intra-group yield - to minimize
- Reporting requirements - to minimize
- Rating – as good as possible
- Currency environment – euro, but pound or Swiss franc should not be a problem
- Treasury centres – existence of an important treasury centre (this is a very important requirement, because the true cross-border cash pooling remains a rare commodity in the marketplace today as banks have struggled to fully understand and manage these issues).

We found, testing all the criterions, that the best variant is to establish the treasury centre for cross-border cash pooling in Switzerland, followed perhaps surprisingly by Finland.
8 CONCLUSION

In the Czech Republic, as with most countries around the world, cash management is one of the most extended treasury department areas. These activities comprise corporate finance, debt administration (loans, bonds, commercial paper and the like), good banking relations, payments systems to suppliers and collections from customers, controlling foreign currency and interests positions to meet the company’s needs, and the technical and reporting support of the above mentioned areas. Cash pooling has very quickly become a part of the Czech corporation’s consciousness. Beside domestic notional and zero balancing cash pooling, Czech banks now offer cross-border pooling, both notional and real, for accounts in certain currencies.

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REFERENCES


Summary

Cash management a cash pooling jako nejdůležitější součást podnikového treasury

Tento příspěvek se zabývá řízením hotovosti v podnikové sféře České republiky se zaměřením na cash pooling a netting. Cash management (řízení hotovosti) patří k nejdůležitějším treasury aktivitám nejen v České republice, ale i celosvětově. Cílem cash managementu je zvyšování likvidity, kontrola peněžních toků, maximalizace výnosů z volných peněžních prostředků a také minimalizace ceny peněžních zdrojů. Cash pooling, jakožto významná část procesu řízení hotovosti, je bankovní produkt, který umožňuje využívání peněžních prostředků v ekonomicky spjaté skupině. Kromě domácího fiktivního a
reálného poolingu, je v České republice běžně používán i přes-hraniční pooling v různých měnách, nejčastěji CZK, EUR, USD.