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INSIGHTS FROM CASH MANAGEMENT, US
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Cash Concentration and Notional Pooling: A Balancing Act

Corporations have long employed liquidity management practices to improve control of their cash, enhance short-term investment capabilities and reduce interest charges. However, the euro's introduction, the evolving role of treasury into a global organization, and the impact of regulatory changes along with market instabilities have further driven the need to implement efficient liquidity structures.

Two of the most commonly used liquidity management techniques offered by banks are physical cash concentration and notional pooling. They can be established as a single liquidity solution or in a combination of various sub-types.

Cash Concentration

Cash concentration describes the physical movement of funds from participant accounts into a single liquidity position in a dedicated target account. This works in both directions; a credit position is moved upward to the target account — usually referred to as a "sweep" — and a debit position is "covered" from the target account. In a zero-balancing structure, the entire debit or credit balance of a participating account is put to zero (from a book and/or value balance perspective) at the end of the day.

Conditional or target balancing is a variation whereby certain parameters can be applied to achieve a core balance (different from zero) to remain in the account or minimum/maximum amounts to be transferred. It is also possible to set fixed dates on which the cash concentration transfers will take place, or limit the intercompany loan streams resulting from cash concentration between different entities.

Along with cash concentration facilities, banks offer value-added services for managing these intercompany loan relationships, such as reports and automated interest posting capabilities. Cash concentration structures support a high level of treasury centralization. Whereas domestic and regional cash concentration services are quite common, only a few banks provide a global cash concentration solution.

Notional Pooling

In a notional pool structure, the debit and credit balances of the accounts within a pool are offset on a "virtual" basis. As the debit balances are fully or partially offset by the credit balances, the corporation receives higher credit interest and assumes lower debit interest. In an interest compensation structure, a full offset of credit and debit balances takes place.

In the ideal case, corporations pay bank interest on a single position after notional aggregation of the balances on the pool accounts. This is often combined with a reallocation of interest to the underlying participating accounts. In an interest compensation or interest enhancement arrangement, credit balances help to cover short positions, but interest is still paid to or from the participating account. Account autonomy is maintained.

Notional pooling techniques can reduce or even eliminate intercompany loans and therefore often support decentralized structures. Corporations and banks often find the regulatory environment for notional pooling to be more complex than for cash concentration services.

Tax and Regulatory Issues
In addition to strategic and organizational considerations, the tax and regulatory environment of the countries involved are important factors in helping you determine which liquidity management technique to select.

Depending on the limitations created by taxes and regulations, corporations often look for a combination of services for their individual structure. It is popular to move funds by cash concentration into a centrally held account in a country that is attractive from a tax and regulatory perspective, with subsequent notional pooling across the accounts on this platform.

Withholding tax on intercompany interest may no longer be common in many European Union (EU) countries, but it remains in a number of other regions, including Asia and Latin America. Thin capitalization rules, which lead to taxation of interest when a certain debt/equity ratio is exceeded, and stamp duties levied on loan transfers can also create issues that may prevent the ideal structure from being implemented. Foreign exchange controls or other cross-border transaction restrictions in some countries may also limit the integration of accounts in these countries into cross-regional and global liquidity structures. However, you still may be able to utilize local cash concentration structures. For example, companies can do this in China under the legal framework for entrustment loans.

Whereas some taxes and regulations limit integrating accounts of some entities, other regulatory changes — withholding tax exemptions, Sarbanes-Oxley, the Single Euro Payments Area — have become key drivers for establishing efficient liquidity management structures.

Market Trends
After implementing liquidity management structures for the euro and US dollar, many corporations are now looking into extending their regional structures or even building up global liquidity management structures. The integration of additional currencies and countries into a global framework is driven by various factors such as regulatory developments (for example, withholding tax exemptions), increasing investment opportunities and meeting global funding requirements. There is a growing need for a tight liquidity risk policy, but there are also technology upgrades on the bank side allowing some financial institutions to offer global liquidity management services.

Central and Eastern European countries joining the EU have created new opportunities to integrate accounts from these countries into existing euro cash concentration and notional pooling set-ups. Some banks now offer global cash concentration services, as well as multi-currency cash concentration and notional pooling services, as the basis for obtaining a view on a single global liquidity position.

The Future Outlook

Despite the legal, tax and regulatory challenges, cash concentration and notional pooling are well-established techniques. They can flexibly combine to allow for alignment with treasury organizational structures such as in-house banks and shared service centers.

Corporations often initiate a phased-in implementation of these techniques by building up local or regional hubs as a first step. Once established, cash concentration and notional pooling are efficient tools for gaining control of the corporation's liquidity. With constant movement toward further globalization and centralization of working capital management, liquidity management will continue to play an essential role.