Good Cash Management = Less Banking

Summary

The most effective route to efficient cash management is to minimise banking – balances at banks and flows through banks – because such third party interactions inevitably increase both risks and costs.

Objectives

My guiding principle for treasury metrics is CERR Cost Effective Risk Reduction. Treasury covers a variety of financial risks such as liquidity (in the sense of cash availability), price risk (foreign exchange, interest rates, et al), operational risk, and so forth. Non financial businesses want to minimise non core risks like financial risks so that they can allocate more capital (which translates to risk capacity) to their core business.

The treasurer's role is to reduce the financial risks in the most cost effective way. A classic example of balancing risk and cost is capital structure. A fully equity funded firm with huge cash reserves will be very low risk, but it will also have a high WACC (weighted average cost of capital) that will materially reduce its competitiveness. On the other hand, highly leveraged firms are more risky, even though they should have a lower WACC (subject to the WACC curve).

The right capital structure depends on the riskiness of the underlying business, and there is no best solution – though the market may provide valuable input through equity and debt pricing. Capital structure is a strategic board level decision.

Cash management is far more generic across most businesses. In the end, all need to collect cash from customers, to pay suppliers, and to manage the resulting balances efficiently. Ideally cash would

just be a utility like electricity or water. The objective is to reduce costs and risks – and fortunately both can be achieved together.

Execution

Cash management can be usefully split into balance management and flow management.

For balances, we want to concentrate all our cash into one global balance available for investment according to policy (which will presumably limit concentration and credit risks).

For flows, we want to minimise the cost and operational risk of payments and collections.

These objectives are best achieved by minimising banking.

Less banking = more CERR

From a balance perspective, if you exclude the market cost of funding the business' net debt (which is a strategic board decision outside the scope of cash management), most of the cost and risk come from maintaining bank balances.

Banks need to charge cost of capital and margins for use of balance sheet. This means there is a substantial spread paid by businesses that maintain both credit and debit balances with banks (including account balances, loans, and deposits).

Pooling cash into one global balance eliminates this spread, and is normally the biggest cost saving that comes from efficient cash management. Pooling also eliminates many risks – both operational and credit – that are associated with dispersed bank balances.

In a similar way, making payments through the banking system incurs bank fees, loss of float, and (for cross border) foreign exchange spreads. Making payments through the banking system is also risky – not so much because of the banks themselves but

because the interface between corporates and banks introduces multiple risks.

The best way to reduce both costs and risks is to minimise the number of flows going through the banking system. For example, intercompany flows can be settled through payment netting or IHB (In House Bank). Third party flows can be minimised through aggregation (payment factory) and OBO (On Behalf Of) (IHB).

The benefits from eliminating or at least reducing banking are far greater than what can be derived from haggling over fees and spreads.

Balance CERR

As explained above, the goal of balance management is one global cash balance. (We can apply the Pareto 80/20 principle here with regard to cash in regulated countries; but even there the same principle applies domestically.)

For those who have not implemented full IHB, and therefore still have bank balances, there are three main issues:

- Cash is spread across legal entities and geographies
- Cash is spread across different banks
- Cash is spread across different currencies

This can be addresses by various balance management tools as follows:

Challenge	Solution
Many entities in many countries	Sweeping & Notional Pooling & In House Bank
Many accounts at many banks	Sweeping & In House Bank

Many currencies	Notional Pooling

For simplicity, the table above does not include intercompany loans (functionally equivalent to manual ZBA, or ZBA is intercompany loans automated by a bank) or interest optimisation (a partial concentration suitable for regulated countries).

The table makes clear that optimal balance management will often require a mix of tools – for example, sweeps to move cash from operating bank accounts to notional overlay bank accounts.

IHB (done properly with OBO so that there is only one account per currency across the group) does an excellent job, but does not automated pooling across currencies. For that reason, many IHBs operate a notional pool as an overlay across their currency balances. (Multi currency accounts can also serve a similar function.)

Flow CERR

From a flow perspective, the objective is to minimise the flows through the banking system. This normally targets two types of flows – intercompany and third party.

Intercompany flows can be eliminated with payment netting and with IHB. Payment netting reduces intercompany flows to one per entity per month. IHB eliminates intercompany flows altogether, because they become book entries across the entities' intercompany current accounts with the IHB.

Third party flows can be sharply reduced through aggregation and lowest cost routing, which is what most payment factories and IHBs do. Aggregation reduces the number of flows, and lowest cost routing reduces their cost by executing them as domestic payments (similar to what banks call cross border ACH).

(These comments may not apply to industries that have industry wide net settlement arrangements in place such as airlines (with IATA) and telecoms (with ITU).)

Conclusion

As shown, the most effective route to CERR in cash management is less banking. This is not a criticism of banks – the risks and costs of banking arise from the third party relationship and are exacerbated by bank regulation. It is more about keeping things simple – not making a payment is simpler than making one – and complexity inevitably increases risk and cost.

It may be interesting to consider how this model will need revision when everyone has accounts with and makes payments through central banks, but that will take a while, so for now less banking equates to better cash management.

Of course, optimising cash management is not the end of the story. One follow on question is what to do with the cash thus concentrated. That will be a future article.

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