Liquidity structures

The Liquidity Overlay: An Outsourcing Candidate?

By Anne Friberg

Can a niche player step in and take the pain out of liquidity management or would that stop short of the possible on the liquidity-efficiency continuum?

Global companies populate various points along a liquidity-efficiency continuum; from highly decentralized organizations with difficulties overseeing global cash balances to highly centralized ones where all control and access to cash is in the hands of corporate treasury. Most, of course, fall somewhere in between. But no matter where on this continuum a company finds itself, an efficient global or regional liquidity management system is a top priority.

Cash efficiency begins with visibility and data aggregation—a challenge that can be approached in different ways. A highly centralized treasury already has many of the systems and procedures in place to gather relevant data from far-flung operations. Whether the central unit is an in-house bank (IHB) or part of treasury, it couldn't exist without them. The greater challenge is for decentralized corporations that want to move closer to the right end of the continuum.

BROAD VS. NICHE

One way is to forge a broader collaboration with an existing banking partner. This is an attractive option for companies that don't require extensive in-country branch networks. Going with a familiar partner can save time; aggregating credit and cash-management business, including overlays, can save money.

In such cases, the liquidity solution—for example in the form of an IHB—can be managed internally, in close cooperation with the relationship bank, or even outsourced to a bank. The problem there is that it's hard to find a bank that's willing to offer full-service outsourcing (see *IT,* November 2005). Most have stopped given liability and profitability issues.

However, many treasuries operate within a more fractured banking environment, e.g., because of a multi-industry corporate strategy that requires multiple banking partners and in-country branches, or because they've grown globally through acquisitions. For these, and other companies that must continue to rely heavily on local bank services, it may be worthwhile considering a specialized provider that can overlay its solution on top of the existing account infrastructure and buffer the treasury from the opacity and unwanted diversity of multiple decentralized treasury-activity points. Plus, a certain level of "bank independence," is always a good way to prevent overly sticky banking ties.

In essence, a niche provider can operate as an extension of treasury in a back-office capacity to process transactions, administer intercompany loans and execute netting and notional cash-pooling activities (see sidebar, left). All of these processes can be integrated into an existing IHB or even used in lieu of it, according to one MNC that had replaced its IHB with the Bank Mendes Gans platform (Bank Mendes Gans, BMG, is a subsidiary of Dutch bank ING).

There's a cost associated with setting up the systems control and compliance framework for liquidity management and transaction processing. For companies, this part of the IHB "resource demand" must be balanced against strategic functions, e.g., determining liquidity strategy.

> ***"For us it was largely a strategy and technology decision; it is not a core treasury function to run an in-house bank, make third-party payments or do netting," said one EMEA treasurer.***

"And, although we have had some headcount-reduction benefits, the biggest benefit of using BMG, after outgrowing our in-house systems, has come from the scaleable systems and the global notional pooling."

INTEGRATE OR DISAGGREGATE?

So why haven't more companies jumped on the niche overlay bandwagon? One reason is the trend toward rationalizing bank relationships and partnering with the bank "for the journey, the long-term evolution of the individual firm's treasury model," said Sean Crooks, head of EMEA treasury, liquidity and investments product management at JP Morgan.

"Tactical outsourcing of such an integral part of treasury's operations is like throwing a blanket over the complexities of an MNC's cash-management structure. It's a quick fix. It may well save some money but the true cost benefit comes from rationalizing the bank infrastructure instead of keeping it static," Mr. Crooks added.

Could it be that the niche overlay liquidity solution just isn't ambitious enough anymore?

ANATOMY OF BMG'S OVERLAY SOLUTION

Combined with pooling or as a stand-alone process, a company can net its intercompany cash flows at its desired frequency by using BMG as a netting center.

Clients upload interco invoices from their AR/AP systems via BMG's web-based service and reporting platform. After the "netting engine" runs, files go back to the client for payment, invoice reconciliation and reporting.

A BMG notional cash pool (see p. 15), lets companies keep existing local bank accounts for domestic payments and collections, but companies also need a local or functional-currency BMG account into which excess local cash is centralized. Negative balances are funded from the company's central BMG cash-pool, thereby minimizing overdrafts and idle cash. BMG notionally pools balances and applies interest compensation, to eliminate FX transactions, interco loans and their tax implications.

"If it's automated, BMG monitors balances daily via MT messages but only moves cash to the pool weekly or bi-weekly based on triggers," said Greet van der Steen, a BMG managing director and head of the Americas. "Over 85 percent of all cash is centralized, leaving some local operational cash. Sweeping is often over-idealized and the costs can outweigh gains." A notional pool should have at least five currencies, a certain level of balances and multiple affiliates in different locations.

"The more global you are, the better and it is simple to establish provided the underlying legal documentation reflects the LE structure correctly," she added. IT

"Pure overlay structures are a legacy of the 1990s, when it was the best a treasurer could do to minimize cash leakage," observed Ron Chakravarti, director of global liquidity & investments at Citi GTS.

"Today, as an isolated component, it may well be attractive to a decentralized organization or one at the early stages of globalizing treasury. But companies are more ambitious now, given advancements in regulation, banking tools, and technology," he continued.

> ***"Treasuries are taking an end-to-end approach to integrating global cash and liquidity management and seeking out 'real-time' global funds management." According to Citi's Mr. Chakravarti, that is what's "squeezing out enormous liquidity inefficiencies that otherwise remain on the table."***

FINDING THE SWEET SPOT

For treasury, the real issue may be identifying whether the liquidity overlay is an area that's ripe for "out-tasking," while treasury focuses on strategic decision making.

While that certainly sounds tempting for frustrated cash managers, it raises an important share-of-wallet issue. "Some companies might have enough business to spread around," noted Dhiru Tanna senior VP, EMEA product management with global treasury services at Bank of America. But for others, it depends on the cost-benefit analysis of outsourcing this piece in relation to other treasury project needs."

If companies carve out the liquidity-overlay component of the banking relationship and hand it off to another provider, cash management banks will likely look more closely at how they get rewarded for the day-to-day (and low margin) transaction processing services that they perform for their clients. Actually owning the account structure and earning money off the balances is a major part of the banks' profitability. Nor is opening an account with yet another institution hassle or cost free (see below).

The bottom line is that whether the overlay niche solution makes economic sense will be determined by how far up the decentralization path a company already is.

Companies that have done the homework can handle liquidity internally or by aggregating bank business. But those delayed by organizational or business model issues can get a quick fix in place as they continue to set their liquidity-efficiency ambitions higher.

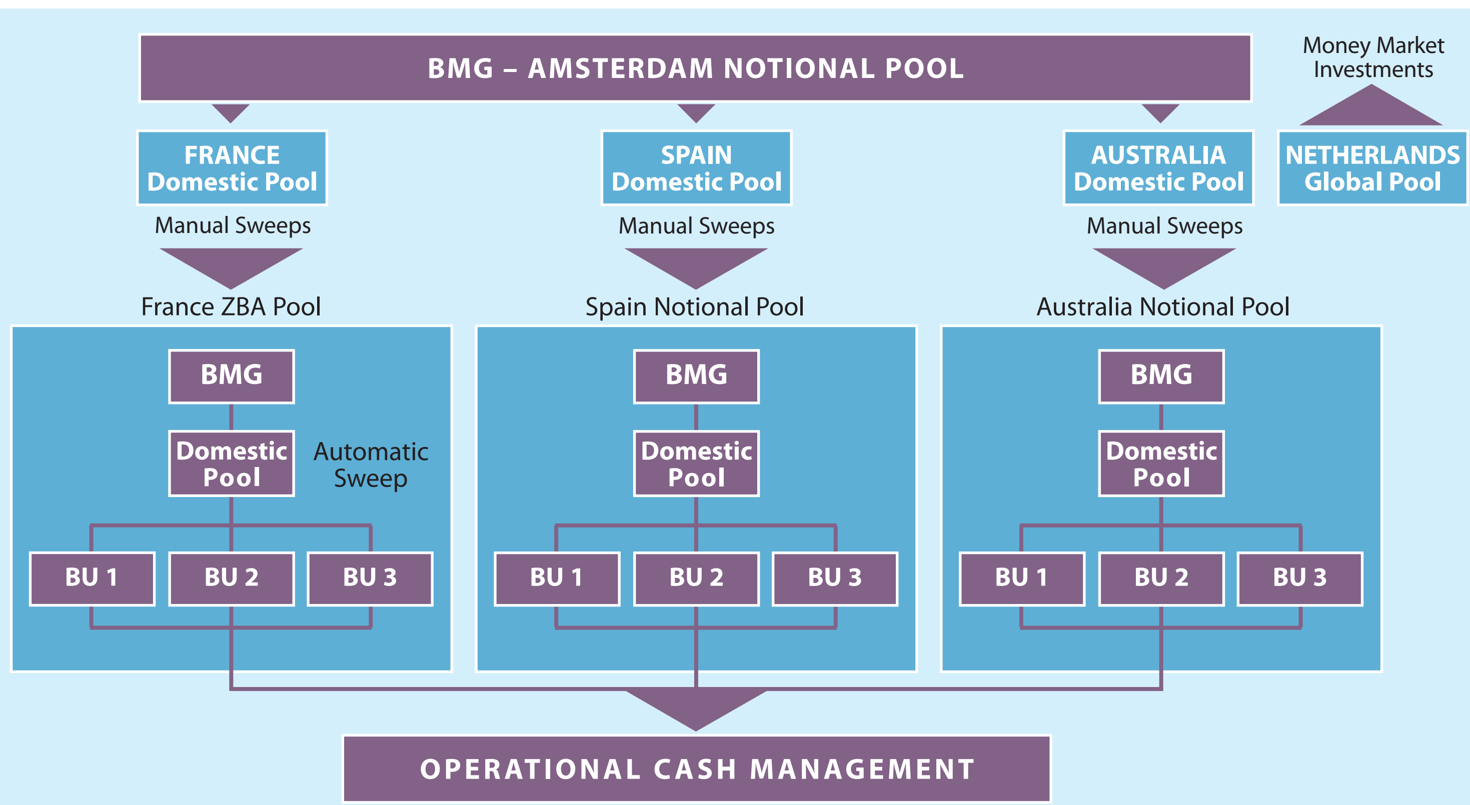
OVERLAY DRAWBACKS

"Stand-alone overlays with periodic cash transfers from the local to the overlay bank leave several issues unaddressed," said Citi's Ron Chakravarti in a presentation at Eurofinance's Miami conference in April.

That's because the bank account structure and execution of cash processes remain localized instead of integrated, while liquidity and information management continue to be manual and disaggregated instead of automated and global.

As a result, uneconomic, often substantial, cash and bank debt positions may remain buried in the layers of local processes, banks and accounts due to timing, data and participation dependencies as well as the costs preventing the daily management of all cash positions. IT

GLOBAL NOTIONAL POOL STRUCTURE



Source: BMG