Die Another Day – The Future of Notional Pooling

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by Bas Rebel, Senior Director of Corporate Treasury Solutions, PwC The Netherlands and Philippe Förster, Director, PwC Luxembourg

Notional pooling is a popular cash management instrument. But over the past few months the debate about its future has intensified. Some believe it will disappear in the next two years, others are convinced that it will survive. No doubt some convictions are founded in business opportunism. Many corporate beneficiaries are sitting on the fence wondering what will happen and how and when they should prepare for alternatives. Treasury professionals know that implementation of any alternative implies a fundamental change in cash management which will require substantial effort and lead time. In the interest of undisturbed and stress-free cash management, clarity on this issue is needed sooner rather than later.

It would not be the first time notional pooling has been declared dead prematurely. Without a good understanding of the issues that triggered the debate and turmoil this time, it is difficult to assess the right moment to jump trains if/when necessary. This article examines the underlying issues.

What are we talking about?

Notional pooling comes in many different shapes and forms, ranging from simple interest recalculation to contractual supported balance sharing. It can be implemented across legal entities as well as within a single legal entity. The currencies of the participating accounts is another dimension to the range of notional pooling products. A special kind of notional pooling is the so-called reference account structure also known as 'Nordic' pooling, in which the owner of the account can be different from the operator. A key characteristic of all notional pooling products is that account balances are not transferred between participating accounts.

Notional pooling appeals to corporate treasurers for different reasons, including operational ease of managing liquidity across the group, wide acceptance by income revenues across the globe and low impact on corporate accounting and business operation. The effectiveness and efficiency of multi-entity notional pooling solutions, however, is dependent on the contractual obligations between participating entities required by the bank (i.e., the cross guarantee or act of joint and several liability). These cross guarantees and other enhancing multilateral contractual obligations are typically hurdles for groups of companies wishing to implement notional pooling.

Under fire

The current debate around notional pooling has some parallels with similar discussions a decade ago, but there are also some notable differences. In 2004, corporate beneficiaries were concerned about the implications of the adoption of IAS32. Although this international accounting standard did not discuss notional pooling explicitly, it did define bank accounts as financial instruments and stipulated the conditions for net representation of financial instruments on the balance sheet as:

1. Contractual agreement to settle outstanding liabilities that can be enforced under all legal circumstances; and

2. A regular demonstration of the intent to settle outstanding liabilities that are represented on a net basis.

At that time, banks, corporate clients and accountants had a vested interest in finding alternative ways of working within the boundaries of this international accounting standard. Corporate treasurers feared that gross representation of pool balances would negatively impact balance sheet ratios and possibly breach bank covenants for no material economic reason. Transaction bankers felt caught in a prisoner's dilemma, fearing loss of substantial business if they did not offer an acceptable solution. For them, any product development cost was immaterial compared to the revenue and client retention at stake.

The storm that is looming today concerns the cost basis of the supplier side (i.e., the banking industry). The Basel III agreement that will come into full force by 2018 sets a framework for risk sensitive capital allocation and liquidity adequacy for the banks concerned, and contains wording defining financial instruments and net representation that is almost identical to that of IAS32. However, unlike a decade ago, it now has implications for capital allocation and liquidity reserves of banks. Transaction bankers will have to compete in the ALCO (Asset & Liability Committee) with their colleagues in lending and other departments for scarce capital and liquidity. This inevitably presents a new dimension in the discussions between bankers and their corporate cash management clients around availability of notional pooling, yield and wallet sizing.

The confusion that is building up can be explained by two factors:

1. Some cash management banks are not subject to Basel III in equal terms; and

2. Each cash management bank has its own strategy on asset allocation, often dependent on the demands of internal competing business lines.

Basel III

Over the past three decades, the Basel committee has worked on frameworks and recommendations with the objectives of improving the sustainability of the financial sector and avoiding systemic risk globally. Although the work of the committee is highly respected, its impact on the global financial industry suffers from two major shortcomings. Firstly, the committee has no formal, let alone legislative, authority. Hence it has little influence on the practical and consistent incorporation of its recommendations in national legislations. Discrepancy in interpretation and national opportunism already explain subtle differences between geographies. The national legislative stance also explains the difference in implementation between, for example, the US and Europe.

Secondly, and arguably more important, the Basel committee's work suffers from the fact that it has no global reach. The committee includes representatives from the G20, Singapore and Hong Kong. This may result in discrepancies between countries, depending on whether they are represented by the Basel committee or not.

The third Basel framework was adopted by the G20 in 2008 and should come into full effect by 2018. EU member states have the obligation to create compliant legislation based on the directive 2013/36/EU [1], commonly known as CRR/CDR IV (approved 26 June 2013).

Consequently it is difficult to see how Basel III can generate a level playing field and mitigate systemic risk across the global financial industry

The impact of Basel III and CRR/CDR IV on notional pooling

Basel III and the CDR IV interpretation introduce two novel ideas to fight systemic risk along with more stringent capital requirements when compared to Basel I and Basel II. The novel 'liquidity coverage ratio' (LCR) requires banks to maintain at all times highly liquid buffers for stressed situations comparable to those during September 2008. Banks have to calculate stressed in- and outflows for the following

30 days determining the highly liquid buffers they have to maintain. In addition, the rules impose a maximum gap of 75% of stressed inflows vs. outflows. A shortfall has to be compensated by holding additional liquidity ready at hand. The second novelty is a restriction on the ability to net positions before calculating the stressed cash flow. Balances cannot be netted across legal entities participating in a notional pool. Some countries also restrict netting of account balances within one legal entity.

Ignoring the subtle differences between national legislations, Basel III undeniably increases the cost of notional pooling resulting from capital allocation and the required liquidity buffer. The wedge between gross and net balances is a leading indicator for comparing the cost pre and post Basel III.

However, these differences do impact the competitive landscape in cash management. One can even argue that they do not create a level playing field for transaction banking. The jurisdiction of a bank's regulator defines the interpretation of capital and liquidity coverage requirement calculations. Consequently, a branch of a foreign bank may have to allocate less capital or liquidity than a domestic bank would have to for the same positions in a notional pool. It could also be that the branch of a foreign bank would demand a different type of guarantee than a domestic bank or a branch of yet another foreign bank would require.

What can be done?

The commercial response of banks will be dependent on the relevant jurisdiction, and also the capital allocation and account strategy. Some banks may discontinue the product but, more often than not, banks put restrictions on the use of notional pooling, modify conditions and/or test the price sensitivity of their clients. These alterations to the products are typically introduced step by step. Yet other banks may see this as an opportunity to attract more cash management business from prospective clients and price notional pooling as a cost leader, at least for the time being. Finally, there is a group of banks that may claim that Basel III is disrupting the market for cash management and therefore requires modification on this point at least. No matter what a bank's response is in the short term, corporate clients have to come to terms with the fact that the conditions and cost of notional pooling will never be the same again. How different reality will be is still too early to tell.

This lack of clarity may not be welcome news for a corporate treasurer who is still getting to grips with multibank cash management infrastructures in which an overlay cash pool ties it all together as part of the wallet distribution and market access policies. Notional pooling is the cornerstone in many overlay structures. Because the end game is still not set in stone, something done now may look redundant in a year's time. On the other hand, migrating the overlay function to another banking provider is a project in itself without necessarily guaranteeing that the new bank can

Note

[1] See also http://ec.europa.eu/finance/bank/regcapital/legislation-in-force/index_en.htm

maintain the offered services under the same conditions. Implementation of an alternative to notional pooling – i.e., zero balance pooling – is an even bigger project and has fundamental implications for tax position, system configuration and ownership of liquidity. This does require careful planning, mapping a vision and, above all, budget.

Corporate treasurers will have to weigh their options and timing of their actions carefully. How long can they afford to be a frog in the pan on a stove? Can they trust that the heat will be switched off in time? For how long will they feel comfortable and when would it be too late to escape getting boiled?

In this type of uncertain situation, the best advice available is 'be prepared'. Don't just talk to transaction bankers about their views on the future of notional cash pooling and their bank's strategy; you should also develop contingency plans should notional pooling become economically inefficient. By understanding the scope, activities, effort, risk and timeline to implement an alternative cash management infrastructure, one can define the 'point of no return for kick-starting change.

Bas Rebel
Senior Director of Corporate Treasury Solutions, PwC The Netherlands.

Bas Rebel's focus is treasury strategy, operations and enabling technology. He brings a wide range of expertise to his clients. Before becoming a consultant 12 years ago, he was responsible for business and application development at a treasury software provider for three years, spent four years creating a European treasury centre for an American multinational and worked in corporate and transaction banking for six years.

Philippe Förster
Director, PwC Luxembourg

Philippe Förster works in IFRS and Treasury. He has over 10 years of experience in finance. He is a member of Global Accounting Consultancy Service, a network of 110 partners and 240 managers that focuses on supporting engagement teams and clients in the application of IFRS. He is also a member of PwC's Global Corporate Treasury Solution, a team of more than 500 professionals located in 150 countries dealing with thought leadership and original research in developments and standards in the treasury space.