Notional Pooling: That Other Day May Not Be Far Away

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

Since our article on notional pooling in January 2016, 'Die Another Day', the debate has continued to accelerate. In that article, we highlighted the potential impact on some banks and uncertainty around timing to formulate an adequate response, however the tone and direction of the IFRIC agenda decision should urge corporate clients who rely on notional pooling to now plan for the worst.

What is the point?

There is mounting pressure by Basel III and CRD IV on the cost of notional pooling products due to capital requirement and liquidity coverage ratio calculations. The discussion partially gravitates around distortion of the level playing field in the transaction banking space as a result of some deviations in how Basel III is interpreted and implemented in different legislations. Closely related is our observation that banks have different opinions on the implications. Some have made alterations to their pooling products that, in their opinion, counter the impact of national regulation.

Another part of the discussion focuses on the preconditions of net representation of bank balances. Because Basel III took its language directly from decade-old accounting standards, the IFRIC agenda decision is pivotal for the viability of the various notional pooling products.

IFRIC new input

While the IFRIC paper technically does not prohibit notional pooling, it makes it practically and economically unviable for corporate clients. The inability to net present bank balances provides a clear guideline as to how the capital requirements and liquidity coverage ratios of banks have to be calculated and also how most banks would need to include these in their financial statements.

The IFRIC agenda decision discusses whether a particular cash pooling arrangement would meet the criteria for offsetting (and then net presentation). Their motivation to reject net presentation centres around the more fundamental question of whether bank balances even meet the criteria to be eligible for offsetting. The key argument is that because bank balances are fluctuating, it is impossible to determine in advance what will be settled. Consequently, if the amount to be settled cannot be defined, one is unable to demonstrate the intention to net settle.

The line of reasoning by IFRIC can be applied to most, if not all, notional pooling structures. Banks and corporates alike can no longer avoid gross representation and have to anticipate a material and potentially prohibitive impact on the cost and availability of notional pooling products.

Undoubtedly, as banks continue to offer notional pooling products to their clients, the break-even point at which notional pooling makes sense economically and operationally shifts upwards more rapidly than we may like. We urge corporate treasurers to build the business case for change and explore the alternatives now.

Unhappy bankers…

Given the sometimes subtle differences in how Basel III works out across legislations, opinions about the survival of notional pooling partially gravitate around the distortion of the level playing field in the transaction banking space. If this is the only argument, it seems highly unlikely that the grander scheme of Basel III would stand up for transaction bankers.

Another topic in the debate centres around the ability to net present bank balances in the notional pool. In this context, you need to understand that Basel III took its language and definitions for the calculation of the capital requirement and liquidity coverage ratio derived from IFRS. IAS32 defines two simple preconditions for net representation:

- Having the legally enforceable right to offset balances under all circumstances; and
- Demonstrating the intent to settle outstanding balances simultaneously or on a net basis.

There is, and always has been, diversity in practice. The debate amongst accountants on notional pooling and IAS32 has never been settled or put to rest.

Over time, auditors have become more rigid in their interpretation of IAS32. Until recently, the stepped up rigidity had little material impact on the popularity of notional pooling among corporate clients because it had no material impact on their cost of funding or bank fees. Bank covenants typically took the net instead of gross debt coverage ratio as triggers for funding cost adjustments or other loan renegotiation.

Given the historical popularity of notional pooling among their corporate clients, it is not a surprise that banks see the product as key to their transaction banking proposition and client retention. Product pricing and product cost leadership are key drivers that explain their management of notional pooling products.

… send treasurers back to square one…

Corporate clients use notional pooling products because they are an effective and convenient liquidity management solution. Notional pooling enables cash managers to manage liquidity across the enterprise and/or across currencies with a single swing account owned by treasury. At the same time, it avoids potential uneasy internal discussions about ownership of cash. It also avoids the need for in-house banking solutions to record and monitor the intercompany liabilities.

The obvious alternative to notional pooling structures is zero or target balancing. The other one might be the virtual account structure. Traditional reference account structures may not be an acceptable alternative as these structures are typically notional pooling arrangements for accounts owned by a single legal entity and consequently do not solve the key issue on cost. To the extent that Nordic pooling structures are interpreted as virtual account structures avant la lettre, they may also be viable alternatives.

The alternative solutions are common in that they pool the liquidity in a single bank account owned by the pool leader. Migrating away from notional pooling therefore will have a major impact on the treasury operating model and supporting technology and needs to be carefully planned.

… to plan for the future…

Of course, the transition plan would require an AS-IS and TO-BE analysis. The business case would not only define the ambition, but also operate as a departure point for tracing the projected benefits of change, or more fundamentally, project completion. The ambition can be anywhere between modifying the minimum and completely transforming the cash management operating model.

As a bare minimum, the plan has to include a bank and systems selection, be it a proposal review, fit/gap analysis or a full beauty contest. There are also many other key elements that drive success. The plan has to address the arguably single most important key success factor in migrating away from notional pooling – stakeholder management. The key stakeholder might not be the CFO, instead it may be the operating company management that would still feel a sense of ownership over the bank balance. This sensitivity can be a result of his or her pride and job satisfaction, but also the result of management performance indicators. Sometimes it can also be linked back to a perceived impact on management liability if the control over cash is taken away. Managing this aspect requires attention and education. It also requires taking feedback from within the organisation seriously as this concern may be wrapped within a wide range of topical and non-topical counter arguments opposing the idea. If not handled with the right care and attention, reservations may turn into opposition or even sabotage.

If zero or target balancing introduces a new intercompany cash account, the project also needs to prepare the underlying documentation. Such a documentation package would include not only the intercompany current account or daily depositing agreement but also the service level agreement. One should have these documents reviewed by the tax department as they might trigger transfer pricing, WHT, VAT and other fiscal and regulatory issues that otherwise could be avoided. A key question is whether the intercompany balance is comparable to cash or a short-term loan/investment.

The project plan would also need careful alignment with the ERP application management. Ledgers may require new IC G/L accounts and, in any case, new reconciliation and posting rules need to be defined to book the ZBA transactions to the right intercompany accounts.

Furthermore the impact on cash and cash flow forecasting reports has to be reviewed, especially the cash forecasting reports that track budget against actual and control over cash. With notional pooling, the bank will keep track of credit lines for individual accounts, but within a ZBA structure credit monitoring has to be done within company systems.

… and beyond

On top of the bare minimum project activities, companies might also seize the opportunity and overhaul cash management by implementing a more advanced payment factory and in-house banking solution. Such solutions typically centralise cash and payment processing even further. It enables companies to centralise the decisions around when and how to pay suppliers. It can also prepare companies for implementing and taking benefit of vendor financing and other supply chain finance solutions. As such, the migration away can be used as a platform that positions the treasurer as the custodian of corporate cash and cash flow.

The economic and operational effectiveness of notional pooling is under severe pressure. This pressure is partially related to the implementation of Basel III and partially related to the accounting treatment for the product. Both are closely related. The implication for corporate treasurers who have built their operations around this cash management product is that they need to revisit the business case rather sooner than later. Should the outcome of the review be that the cash management operation model is longer viable, they still have to decide how to fix the issue. While the minimum fix still touches key aspects of the operating model, one should also think about the opportunity that is presented to demonstrate the important role that can be played in executing the business strategy.

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 Solutions team, with more than 500 professionals located in 150 countries dealing with thought leadership and original research in developments and standards in the treasury space.

Claire Howells
PwC UK

Claire is an IFRS financial instruments and treasury accounting specialist in PwC's Global Corporate Treasury Solutions Practice. She is based in London.