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Impact of IFRS and Basel II on Cash Management

Robert Bogaardt, Orchard Finance Consultants - Wim Lambrecht, Orchard Finance Consultants - 26 Sep 2005

IFRS and Basel II will have accounting and pricing consequences for notional pooling. To be prepared, companies must consider their strategy now in order to be ready for the significant changes.

Most companies currently prefer notional cash pooling[1] to zero balancing as an automated liquidity management technique. The biggest advantages of notional pooling are that no intercompany relationships need to be recorded and subsidiaries are not affected as much. Within the next few years notional pooling faces significant changes caused by two important events: the introduction of IFRS and Basel II.

The changes due to IFRS are dependent upon the (accounting) choices made within a company and should therefore not affect pricing of the notional pooling product. The consequences of Basel II are more or less outside the company's control. It changes the way banks should treat notional pooling to avoid capital reserves and, in our opinion, will have a considerable impact on pricing levels. In the short run, this article will be useful for companies that are planning to change/upgrade their notional pooling structures or that are thinking of setting up a notional pooling structure for the first time[2]. For companies that already have notional pooling structures in place it may be wise to think about how to deal with the changes caused by IFRS and anticipate the Basel II implications.

Implications of IFRS

Contrary to what some people believe/state IFRS does not prohibit notional pooling. It does make it harder (but not impossible) to record the net cash position on the balance sheet by offsetting the notionally pooled debit and credit balances. Companies are therefore risking increasing balance sheet totals by having to record both the total of all debit balances as well as the total of all credit balances within the cash pool(s). Besides the longer balance sheet implications and, depending on the way the calculations are made, this may have consequences on return on capital as well as on solvency ratios. The lower solvency ratios may increase the default risk of financing arrangements if these are tied to solvency ratios. Note that the problem is strictly accounting related. The interest result of the cash pool and cash flows of the company (presuming the company is not hampered by a decreasing solvency ratio) should not be affected at all.

Dealing With IFRS

Although there does not seem to be one clear and undisputed standpoint from the auditors at this time, it seems to be that when the various bank account balances are physically settled periodically, companies are still allowed to post the net balance of the cash pool(s) on their balance sheets. Currently, there seems to be some consensus that periodically means at least quarterly. This means that companies that want to report the net balance of the notional pool should at least quarterly balance all the accounts in the notional pool to zero. In our view there are a few solutions for companies that want to avoid lengthening their balance sheet:

1. **Physically balance the accounts to zero quarterly.** If the settling/balancing is done on the last day of the reporting period the company avoids all interpretation issues because it will report the actual (netted) balances. The disadvantage of this periodic settling is of course that intercompany balances are created which will need to be booked and that the resulting interest calculations need to be made. Companies were trying to avoid this by notional pooling.
2. **Only balance debit or credit accounts.** To reduce the number of transactions to a minimum, companies can fund all accounts with debit balances when the cash pool total shows a positive amount, or upstream the cash from all accounts with credit balances when the cash pool total shows a negative amount.
3. **Manage accounts according to net position.** Another solution, assuming the company has a net debt position, is to convert part of the credit facilities to current account overdraft facilities on all bank accounts and keep all bank accounts in debit positions. If the company is able to negotiate good interest rate spreads[3] with the bank it may refrain from notional pooling all together. If it is not able to negotiate these tighter spreads the company can borrow the pool balance in the money market and decide to refrain from this on the reporting dates only (the moment at which the money market interest rates tend to be higher anyway). For companies with a net cash position, the reverse may be considered (in this case it will also not benefit from the higher interest rates on reporting dates).

Implications of Basel II

We believe that Basel II may have a far bigger impact on notional pooling than IFRS. Basel II will, first of all, make it harder for banks to net a client's negative balances with its positive balances and may therefore result in banks having to reserve capital for the compensated negative balances; and secondly, Basel II requires banks to formalize all overdraft possibilities on a gross basis and include all formalized credit lines in the calculation for capital requirements even if the lines are currently undrawn. This will make notional pooling more expensive for the banks and therefore (eventually) for the corporates. These effects are the result of several changes between Basel I and Basel II (preliminary and unconfirmed). The proposed changes that may impact notional pooling the most are:

- **On balance sheet netting will be harder.** Under Basel I banks are allowed to net debit and credit balances of companies on their balance sheet. This will become much harder under Basel II. The actual text[4] of Basel II now states that to be able to calculate capital requirements on the basis of net credit exposures, banks will need 'legally enforceable netting arrangements for loans and deposits' subject to the following conditions. The bank:
  - has a well founded legal basis for concluding that the netting or offsetting agreement is enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or bankrupt;
  - is able at any time to determine those assets and liabilities with the same counterparty that are subject to the netting agreement;
  - monitors and controls its roll-off risks; and
  - monitors and controls the relevant exposures on a net basis.

This implies that even if the bank is allowed to net the positions it will require scrupulous assessment of the legal risk in the different jurisdictions and therefore increased legal costs. These will most likely be passed on to the client[5]. Also the bank will need to perform constant monitoring of the collateral position. Even if this is done in a satisfactory way some issues still remain. For example, the Basel II text[6] states that the bank may use as collateral 'cash on deposit with the bank'. The question is: is this cash in the current account or only cash on time deposit? Also, for netting amounts in different currencies, the banks need to apply a cut (standard discount factor is 8 per cent) on the collateral amount.

- **The use of uncommitted (daily cancellable) credit lines will be harder.** Notional pooling has the biggest advantages for companies that have simultaneous positive and negative current account balances combined with high volatility of those balances. Therefore the company will require overdraft facilities on at least several accounts. In principle, under Basel II banks will also need to reserve capital for the undrawn portion of the credit lines and overdraft facilities. Avoiding this, if at all possible, will require a lot of work (set-up and monitoring) from the bank.
- **Banks will also need to reserve capital for operational risks.** Basel II will introduce capital reserves for operational risks as well. Banks can use one of three methods to calculate the operational risk capital reserve. In the two simplest methods banks should apply a capital charge of around 15 per cent on the positive annual gross income (in the second method of the business line income). In the most advanced method the capital charge will be based on the bank's internal operational risk measurement system. In which case lower risk products

require a smaller capital charge.

The above mentioned effects may be smaller for better rated companies (A- and better) because those counterparties will require only 20-50 per cent of the current 8 per cent capital levels as shown in the box below.

Credit	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk Weight	20%	50%	100%	150%	100%

However, most companies are rated BBB+ or lower so that the required capital levels will at best remain the same as under Basel I.

Dealing With Basel II

It seems very likely that under Basel II notional pooling will, especially for lower rated companies, become difficult and definitely much more expensive, due to the bank's increased legal and control costs and/or capital requirements. Zero or target balancing can solve part of the problem because:
1. The bank will not have to worry about whether the requirements for on balance sheet netting are met or not; and
2. The bank will not have to set up and monitor so many credit lines because the company will provide for local funding internally. If the company opts for the more expensive solution, whereby the account balances are restored by the beginning of the next business day, it will reduce the need for intra-day facilities as well.

Every company should make its own assessment of whether the (extra) direct and indirect costs of zero balancing outweigh the (extra) cost of notional pooling under Basel II. This can best be done by making an analysis of the cash flows and (volatility of) cash balances and by asking several banks to quote for both options.

Conclusion

IFRS and especially Basel II will have accounting and pricing consequences for notional pooling. We advise companies to contact their banks and auditors to identify what the consequences will be for them. The rising pricing levels combined with the wish for periodic settlement may give rise to analysis of the usefulness of existing or planned notional pooling solutions. The process[7] of setting up an automated liquidity management solution takes time. Companies should start investigating this issue sooner rather than later. Basel II will be operational in 2006 - just three months away.

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[1] With notional cash pooling no transfer of funds is needed. For interest computation purposes, the banks treat all the bank accounts in the notional pool as if there were only one account. When companies opt for zero balancing, the bank automatically sweeps all positive balances to one account and funds all negative balances from that same account. One of the biggest drawbacks of this method is that intercompany balances are created that need to be accounted for and on which interest needs to be calculated and paid.

[2] Please be advised that especially the Basel II implications are hard to predict, because Basel II is first of all still a document under construction, which means that parts may change before inception. Secondly the text of the latest document (Basel Committee on Banking Supervision: 'International Convergence of Capital Measurement and Capital Standards', June 2004) is not always precise. Banks, auditors and regulators are as yet not certain on the exact implications of Basel II with respect to notional pooling. This article is based on the laws and rules as understood by Orchard Finance Consultants. Other market participants may have a different interpretation of the regulations and therefore another outcome.

[3] Good means that it should be in line with spreads paid on credit facilities or loans.

[4] Paragraphs 139 and 188 of June 2004 Basel II document.

[5] We have already seen an example of this in the answer to a recent 'Request for Proposal' we sent out for a client.

[6] Paragraph 145 of June 2004 Basel II document.

[7] This includes inviting several banks, writing and analyzing 'Requests for Proposal', negotiations and signing contracts, opening and closing of accounts, internal changes, etc.