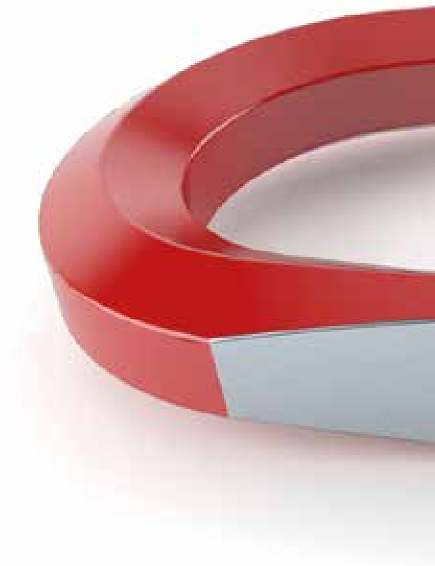

Small and Medium Enterprises in a globalised, post-crisis world

Reacting to new treasury risks and challenges with cash pooling solutions

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Different cash pooling solutions and tools have been available to companies for some time now. However, as companies act in a changing, increasingly globalised environment, the strategic importance of cash pooling becomes ever more important in facing daily challenges.

While mature Multinational Corporations (MNCs) mostly already have professional cash management solutions, many Small and Medium-sized Enterprises (SMEs) are less well equipped.

Facing market, financing and operational risks through entering international markets, SMEs require more professionalised cash management solutions, such as cash pooling. These can assist them in limiting their exposure to market, financing and operational risks. However not all cash pooling tools are equivalent and in order to limit exposure to risk optimally, SMEs will need to choose cash pooling solutions carefully. Banks will need to offer solutions that can be adapted to the needs and particularities of SMEs, which are flexible and integrated.

The question that arises is:
'Are today's financial institutions sufficiently equipped to provide these solutions to SMEs?'

Introduction

Often overlooked regarding their importance to the global and European economy, SMEs represent 99% of all businesses in the European Union and are responsible for 65% of employment and €3,666 trillion[1] in value added. As they are reacting to a changing environment, SMEs are increasingly becoming international and their contribution to the economy is likely to remain high. Increasingly international and in a post-crisis world, SMEs need new cash management solutions that can help them manage new market, financing, liquidity and operational risks.

1 *European Commission, Annual Report on European SMEs 2013/2014*

A changing environment for SMEs

As globalisation is becoming an increasingly important reality, with more competition from abroad, but also an immense array of opportunities for new markets, SMEs are progressively jumping on the band wagon and becoming international. A survey carried out by the European Commission in 2009 showed that 42% of European SMEs are currently involved in international business activities and 25% of European SMEs are exporting products to foreign markets[2].

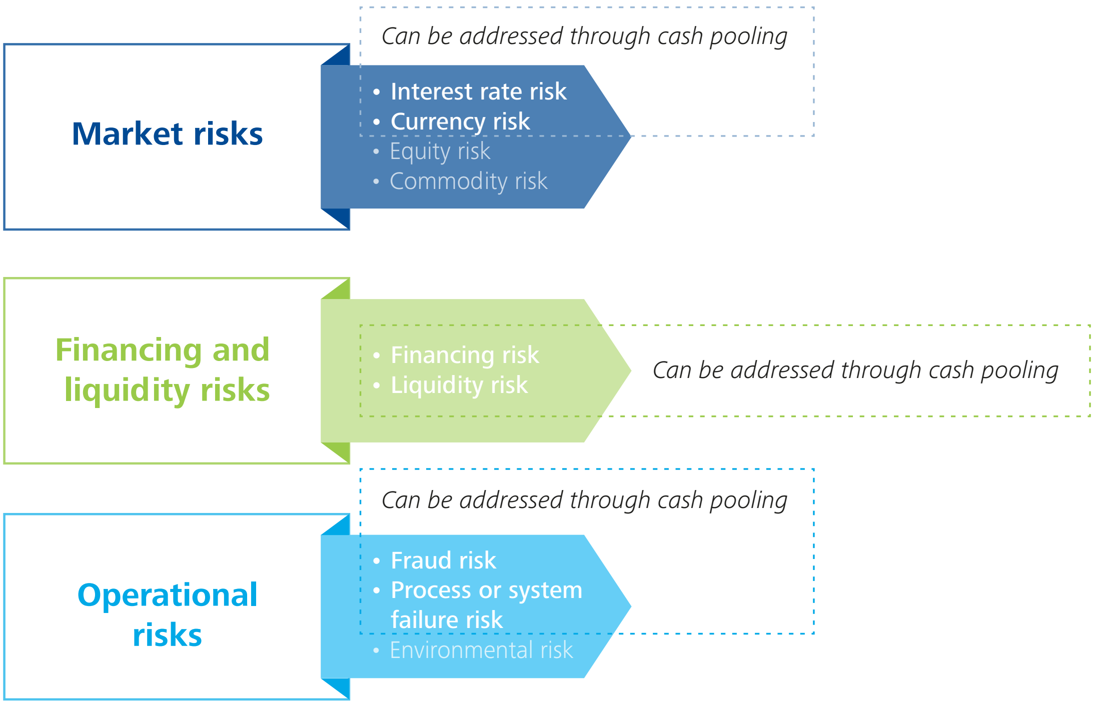
With the World Trade Organisation (WTO) forecasting international trade flows to rise by 3.5% in 2014 and 4.0% in 2015[3], the development towards increasing internationalisation of SMEs is likely to continue with more and more SMEs having more and more complex structures to manage.

Focus on cash pooling

- What is cash pooling?
  Cash pooling is a cash management technique used by companies to consolidate their credit and debit positions across multiple accounts. Different cash pooling solutions exist, notably physical and notional cash pooling

- What is the difference between physical and notional cash pooling?
  The main difference between physical and notional cash pooling is that with notional pooling, there is no physical transfer of funds between accounts to balance, while physical pooling involves a physical transfer of cash between accounts

Figure 1: Cash Pooling can help SMEs in addressing some of the treasury risks they face



2 *European Commission, Annual Report on European SMEs 2013/2014*
3 *www.wto.org/english/news_e/pres14_e/pr722_e.html*

As a result of adapting to the changing environment, SMEs will increasingly be exposed to market risks and will need to adapt their cash management strategies

Traditionally working tightly with one or a limited number of house banks in domestic markets, the shift towards internationalisation is increasingly pushing SMEs into a more complex multi-bank, multi-currency environment. SMEs need to adapt their treasury and cash management strategies when adapting to the changing environment. Through internationalisation, SMEs will typically increase the number of subsidiaries, as well as the number of cross-border activities leading to a higher exposure to market risks.

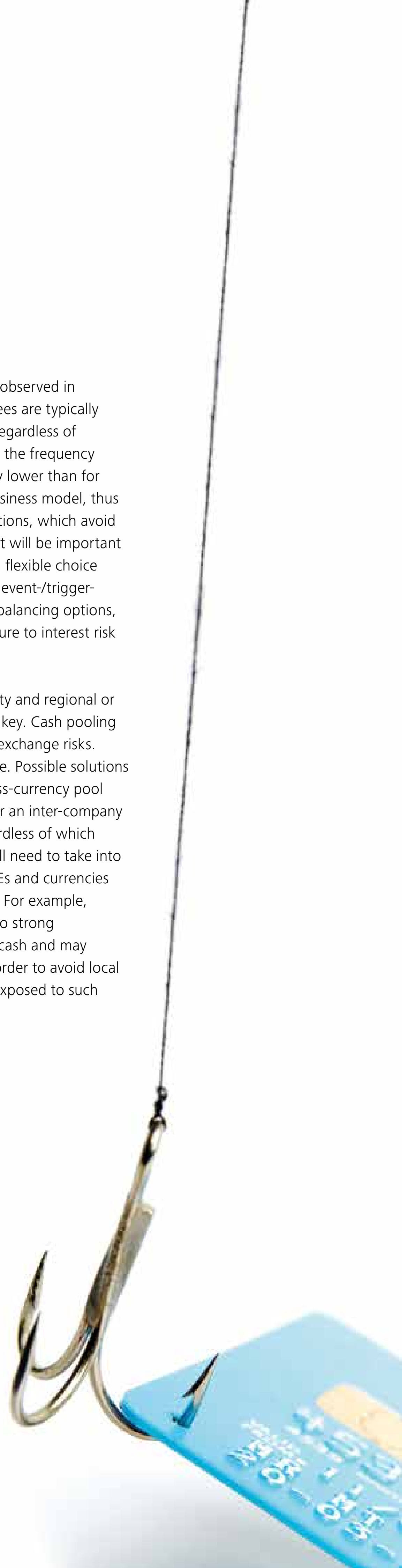
Market risks, to which SMEs are mainly exposed, are interest rate risks and currency risks. Developing international subsidiaries will require SMEs to set up additional bank accounts in the countries they are entering. As the number of bank accounts that an SME possesses increases, the probability of excess or insufficiency of cash balances on the different accounts increases. This results in a significant exposure to losses due to interest rate fluctuations, which intensifies with the amount of excess or insufficient held.

As cross-border activities increase, it is also likely that the number of currencies in which a company is active will increase. As this happens the transaction-related risk (the risk that the cash flows and profits of the company will be impacted by movements in foreign exchange markets) will increase. This risk is heightened by geopolitical developments in international markets and attractive emerging markets in particular.

Cash pooling tools can assist SMEs in this context, as balancing activities will consolidate cash positions, reducing excess, idle cash as well as debit positions on the different accounts and reducing interest risk. However, SMEs have specificities that are different to MNCs and tools offered for SMEs must take these differences into account.

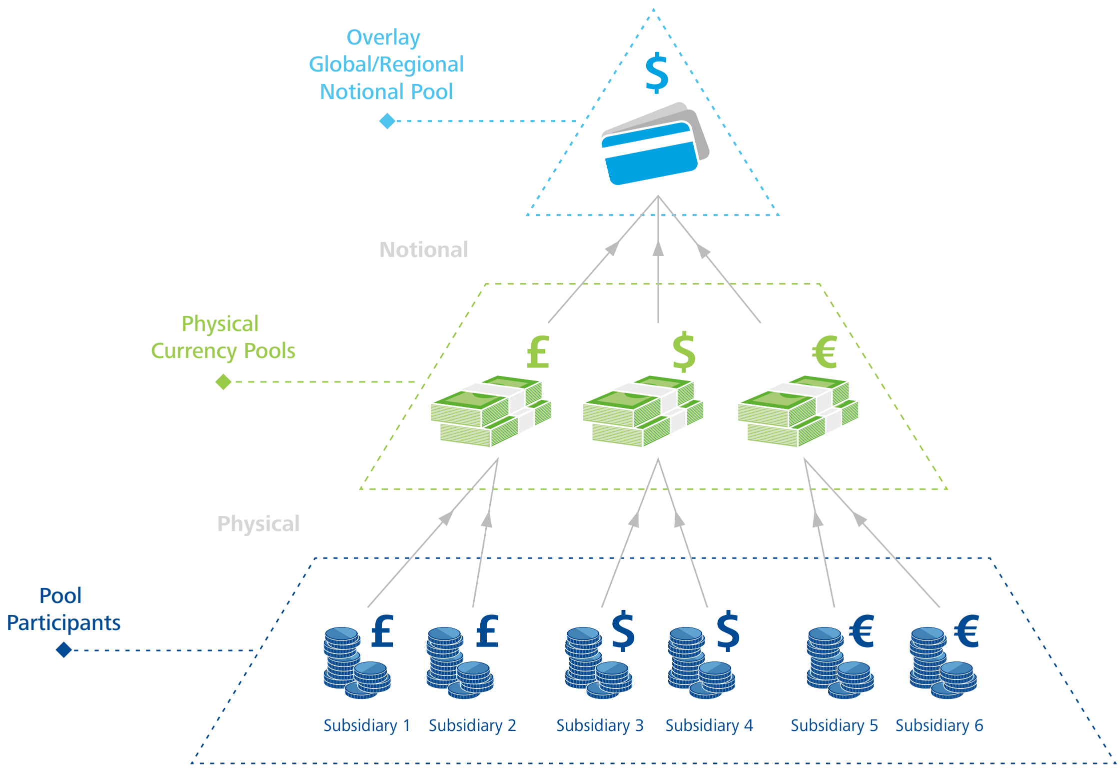
For instance, current pricing models observed in the industry show that transaction fees are typically charged per sweeping transaction, regardless of the amount of the sweep. For SMEs, the frequency and regularity of transfers are usually lower than for MNCs, and depend highly on the business model, thus requiring banks to offer flexible solutions, which avoid unnecessary transfers. In particular, it will be important for banks to offer tools that permit a flexible choice of frequency of sweeping (including event-/trigger-based sweeping), as well as flexible balancing options, allowing SMEs to reduce their exposure to interest risk without charging unnecessary fees.

In dealing with currency risk, flexibility and regional or global integration of the tool will be key. Cash pooling will allow an SME to reduce foreign exchange risks. Different possibilities exist in this case. Possible solutions include the overlay of a notional cross-currency pool over single currency physical pools or an inter-company loan-based physical cash pool. Regardless of which option is chosen, however, banks will need to take into account that business models of SMEs and currencies in which they are active vary greatly. For example, while certain SMEs will be exposed to strong geographic seasonal fluctuations of cash and may therefore prefer physical sweeps in order to avoid local cash shortages, others may be less exposed to such fluctuations.



Flexibility regarding currencies offered in the pool or the master account as well as proposing different solutions is therefore essential in supporting SMEs to reduce foreign exchange risk. To support SMEs in their risk assessment process, tools need to offer an integrated view of the different cash positions across currencies. Providing such an integrated view will assist the central treasury in identifying and assessing currency risks.

Figure 2: Single currency physical pools with a notional overlay pool allow the reduction of currency risks



Financing risk and liquidity risk have become more significant for SMEs following the crisis and efficient cash management can help reduce these risks

While globalisation has significantly affected SMEs in Europe and around the world, the financial and economic crisis is also a non-negligible factor. During the financial crisis, SMEs appeared to be less vulnerable to the effects of the financial crisis than larger MNCs[4]. However, in the post-crisis era, the environment has become more and more difficult for SMEs, who are finding access to short and long-term funding difficult. As the annual report on European SMEs 2013/2014 demonstrated, access to finance is the second most important issue for SMEs in Europe[5]. SMEs are therefore facing an elevated financing and liquidity risk.

To reduce the financing risk, i.e. the risk that the company will be unable to finance itself, or pay too much for financing, or the liquidity risk, i.e. the risk of having insufficient liquidity to meet everyday variations in cash flows and working capital requirements, an SME needs to optimise capital allocation. Cash pooling solutions may assist SMEs immensely in this context.

Firstly, through a well-integrated, flexible tool with real-time visibility of consolidated cash positions, the organisation becomes more agile and capable of reacting to short-term liquidity issues. A consolidated view of cash positions allows the treasury to use idle cash resources, which may previously have remained unused, to fill short-term cash shortages.

4 *European Commission, Annual Report on European SMEs 2013/2014*
5 *European Commission, Annual Report on European SMEs 2013/2014*

The identification of idle cash resources may even permit the reallocation of treasury excesses into long-term capital, increasing available resources for long-term financing. Secondly, the automated sweeping capabilities of modern cash pooling tools will allow SMEs to reduce their interest charges by optimising cash positions.

This will help to improve the interest coverage ratio, which is increasingly used as an indicator by banks when evaluating potential loans. An efficient cash pooling solution can thus help companies to have financing more readily available.

By becoming international, SMEs enter a multibank, multi-country environment and operational risks linked to the treasury function increase

As the international presence of an SME becomes more pronounced, the governance of the different international presences becomes increasingly complex and difficult to control and the number of banks with which SMEs interact increases. Fraud risks, as well as the risk that processes or systems may fail increase.

Operational risks caused by a reduction in control, such as fraud risk, can be reduced through cash pooling solutions. Advanced cash pooling tools provide real-time visibility of all cash positions and cash movements and consolidate all activities in a central tool, which allows the centralised treasury to control and verify transactions. Optimally, banks will provide tools to SMEs that permit an integrated view of all accounts in a single flexible online tool, which is accessible at all moments. This should also integrate an overview of third-party banks and international accounts in the single tool.

This will be of particular use to SMEs, who typically have a strong link with one or two house banks. Moving into international markets will increase the number of banks with which SMEs will need to interact and new processes and systems are required.

As new systems and processes will not have systematically been tried and tested, there is a heightened risk of these failing. If the existing house bank can therefore provide an integrated tool showing all accounts with different banks, this can significantly facilitate the move towards a multi-bank environment for SMEs and reduce the risk. This additional service can furthermore contribute to further strengthening the relationship between the bank and the customer.

Conclusion

- In the context of globalisation and the aftermath of the financial crisis, SMEs are acting in a new competitive environment and facing new treasury risks
- To reduce their exposure to the new treasury risks, specifically market, financing and operational treasury risks, SMEs need new robust cash management tools
- Innovative cash pooling tools in particular can help to reduce the discussed risk exposure
- Considering the significant economic importance that SMEs have in today's economy, banks could benefit significantly from providing specific cash management tools to SMEs
- In order to capture the significant benefits associated to servicing the cash needs of SMEs, banks will, however, need to understand the particular needs of SMEs and adapt their offer to capitalise on their existing client base