Basel III—The End of the Line for Notional Pooling?

Basel III may spell the end of notional pooling, a familiar liquidity management tool. Notional pooling has always been a challenge because it is unpopular with some regulators, raises tax concerns with others and is often opaque from a cost standpoint to potential users. These challenges are sometimes offset by notional pooling's conceptual simplicity and other benefits. (For more information on approaches to cash pooling we recommend "Cash Pooling—A Treasurer's Guide" which is available without charge on **treasuryalliance.com**.)

Notional pooling is achieved by having a bank create a shadow or notional position from the pooling participants' accounts that reflects a consolidated cash arrangement on which interest is paid or charged. The objective is to reduce the interest expense incurred by entities in an overdraft position. Because there is no movement of funds, the pooling is referred to as notional, and the legal and tax separation of the pool participants—who share a common parent—is maintained and the requirement for intercompany loans is avoided.

The concept of notional pooling is simple and beguiling. The reality is somewhat different as the lack of money movement is frustrating to local tax authorities who tend to scrutinize notional pools with vigor or prohibit it entirely. While intercompany loans are not required, most jurisdictions—the Netherlands being a notable exception—require cross guarantees from participants. This provides documentary support for the banks which are effectively holding non-performing loans on their balance sheets. To show that this is not the case and justify the accounting treatment, banks use the cross guarantees to enable the right of offset and the ability to use surplus funds to cover deficit positions.

The issue of offsets has become more critical in recent years due to changes in International Accounting Standards (IAS). Under accounting standard IAS 32 (Financial Instruments: Presentation), positions cannot be netted unless the company has a legal right of offset and can show on a periodic basis that an offset has actually taken place.

This has not been a concern in the US because of different accounting standards and the fact that notional pooling is not practical (overdraft banking is not permitted and, historically, interest was not paid on demand accounts). For companies with operations outside of the US this accounting standard is a factor. European banks have addressed it by periodically sweeping funds into a single account and then immediately reversing the transactions before the FX rates change. While this demonstrates that the offsets can be effected it does impact the cost of offering notional pooling.

The liquidity ratios that form the heart of Basel III bring the issue of statutory versus notional accounting front and center. While periodic demonstration of offset may satisfy the accounting standards, national regulators enforcing Basel compliance are more likely to look at the actual accounts. They may require that banks use gross amounts in calculating and reporting liquidity ratios. This will in turn oblige banks to keep more liquidity on their balance sheets or reduce the number of accounts. Overdraft balances, which are masked by notional pooling structures, may need to be reported. Basel III assigns a poor risk weighting to overdrafts and is therefore likely to require an increase in regulatory capital to support them. Formal credit lines supporting the overdrafts might soften the blow but will not entirely remove the need for additional capital even if they are never used. This will all combine to raise the cost of notional pooling arrangements.

To date banks apparently have not passed along the increased costs in notional pooling that resulted from the IAS 32 accounting standards. Whether for competitive reasons or a lack of awareness of the actual cost, this has reinforced an illusion that there are no fees associated with notional pooling. Bank clients do not see specific charges because there are no explicit transactions. Banks have gone along with this by taking compensation through FX and interest rate spreads. Basel III is likely to upset this arrangement and banks may rethink their willingness to offer notional pooling due to the impact on liquidity and capital requirements. A number of European banks have already begun restructuring their balance sheets and reducing loan commitments to targeted customers to prepare for Basel III requirements.

Companies where all participants are cash positive may also be impacted. In this case the banking arrangement, while called notional pooling, is actually interest optimization. This potentially allows banks to reward customers for cash balances held in countries where interest cannot be paid on a current accounts such as India or China. Under Basel III the question arises—are these balances operating or non-operating and what is the average tenor?

The end result is that notional pooling will almost certainly become more expensive and some banks may stop offering it to all but their very best clients giving preference to those with high balances and little or no history of overdrafts.

Physical and notional pooling are both well-established methods of liquidity management and the decision to choose one approach over another requires careful consideration. Many companies are initially attracted to notional pooling because of its conceptual simplicity and the fact that much of the work is done by the bank. As Basel III and other related regulations are implemented over the next few years that simplicity will come at a cost.

Treasury Alliance Group's work with corporations and banks on pooling indicates that physical pools are preferred by both corporations and banks and currently account for more than 80% of all pooling structures globally. We anticipate that this percentage will rise as Basel III is implemented and we may see the end of notional pooling as a product offering for many banks.

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