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CASH POOLING AS A STATE-OF-THE-ART CASH MANAGEMENT METHOD IN THE CAPITAL GROUP

Summary: Companies in the capital group, due to the large amount of cash flows between related parties, some of which show a surplus and other financial shortages, use modern financial services in order to optimize the financial results of the group. Cash pooling is one of these services.

Keywords: virtual cash pooling, real cash pooling, optimization of financial flows, capital group.

1. Introduction

Companies with extensive operations usually do their business through a number of separate entities, usually joint stock companies. The formation of separate companies, i.e. a specific diversification is a consequence of the management's decision aiming to seek to reduce (or minimize) the risk involved in the company's operations. In the event of financial difficulties of one of the companies, the whole group will not suffer the negative consequences. However, companies are only seemingly independent from each other, and actually there exist networks of ownership relationships, forming the so-called "capital group" [Matyszewska 2010, p. 16].

The source of financing of assets of businesses operating independently, in addition to their own assets, is also derived from bank credits. For companies belonging to a capital group banks offer a new, non-standard method called "cash pooling".

2. The cash-pooling service structure and its types

The capital group is typically comprised of many companies, each with a separate bank account. "Cash pool" is a financial service dedicated to just such entities – it is a specific facility for the most efficient use of cash held in bank accounts of companies within the group. Under the cash pooling service, the bank called the "pool leader" at the request of the members of the group manages the accounts of all entities through the so-called "consolidated account".

As a result of cash pooling, the interest calculation method is more favorable for the group (optimized), than in the case of charging it separately for each account. This is due to the fact that in the first step the bank consolidates the balances of all accounts of the group's companies into one balance and only then does it charge the interest. In other words, the cash surplus (positive balance) of the accounts of individual companies is invested in the cash shortages of accounts which have a negative balance at that time.

By using this type of solution, the interest result of the participants of cash pooling is far more beneficial than the sum of interest results of individually invested surplus of cash and, at the same time, there is no need to bear the individual costs of financing by each company. An important advantage of the concept of cash pooling is also the possibility of aggregating the temporary surplus of funds of each party in order to compensate for the temporary shortages of other participants of the group. The result is minimization of the credit cost incurred by group's members through the so-called "internal lending" by the appropriate use of funds available within the group. How the cash pooling system works is shown in Figure 1.

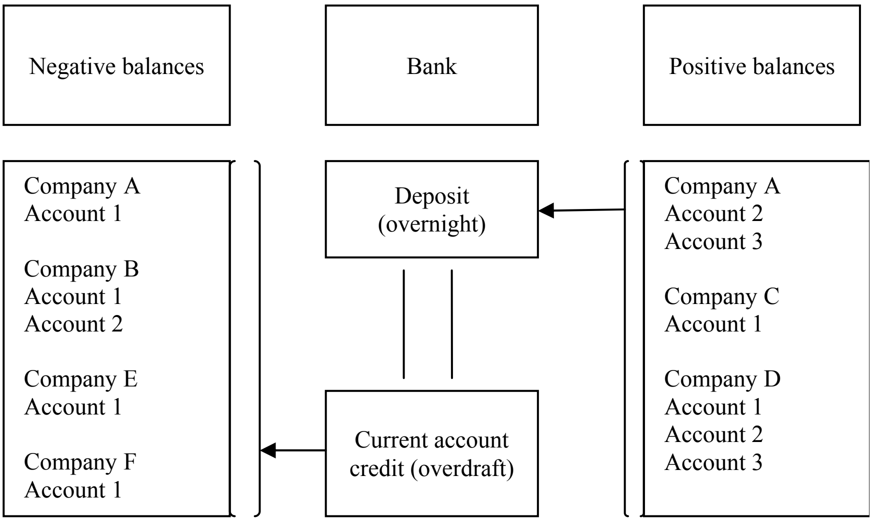

Figure 1. The most commonly used form of cash pooling in the group – aggregation of funds

Source: [*Cash Pooling*… 2010].

The most widely used mechanism of operation of cash pooling lies in the fact that the summary account in which funds are collected under the cash pooling service is comprised of the sub-accounts for each company of the group (see Figure 1). The positive balances of these companies' subaccounts are transferred to the main account, being the "cash reservoir" for companies which have negative balances in their accounts at the time. These transfers can also be made several times a day, depending on the demand of the cash demand of the participants of cash pooling. If the total of surpluses on the aggregate account is insufficient, the bank offers to lend money on the standard terms – under the credit line [Trusiński 2010; Dłubak 2006, p. 42].

In economic practice there are three forms of cash pooling [Sierpińska and Jachna 2007, p. 221]: notional cash pooling, zero-balancing cash pooling (real cash pooling), near-zero cash pooling (target pooling).The first form consists only in offsetting the interest (without transferring capital), while the second and third method consists in aggregating cash in the main account.

In “notional cash pooling”, the aggregate (main) account of the group actually exists, but it operates as a virtual account, i.e. despite the emergence of both positive and negative balances in the sub-accounts of individual companies in the group, there is no actual transfer of cash to the aggregate (main) account, i.e. they are transmitted only “on paper”. The aggregate balance is established without physically transferring the funds. This is the so-called “virtual consolidation”. Even so, the bank calculates interest on the consolidated balance of the whole group, which is the sum of all positive and negative balances, making it possible to reap tangible interest benefits. However, they are smaller in comparison with real cash pooling. The bank must maintain reserves for all assets and in determining the reserve it also takes into account the balances on the source accounts, in spite of their aggregation. The benefits of virtual consolidation are therefore necessarily reduced by the cost of maintaining the mandatory reserves. This solution is typically used when the entities of the group hold accounts at one bank [Sierpińska and Jachna 2007; Czyżykowska 2006].

“Real cash pooling” consists in the actual transfer of funds from the auxiliary accounts to the main one, i.e. the balances are aggregated on the consolidated (main) account as a result of the actual transfer of funds. The transfer takes place automatically at the end of each day or after every transaction, or after a specific limit is exceeded. At the beginning of the following day, the funds are returned to the accounts of participants. The balance of the main account is the basis for calculating the interest [Tomala 2003, p. 2].

The third type of cash pooling, called the “mixed type” (“near-zero cash pooling” or “target pooling”), is a variation of the previous concept, except for that at the end of the day a predetermined balance is created in individual accounts, and the main account receives only part of the funds. Transfers do not result in “zeroing” the balances at the end of the day.

Regardless of the form of cash pooling chosen by the group members in the cash pooling contract, such items as the principle of interest of the global account, distribution of interest calculated on the balance of the aggregated account, forms of investment of cash surplus, as well as remunerating the pool leader, i.e. the party managing the cash pooling (which can be either a bank or a member of the capital group). It must be stressed that the cash pooling service belongs to the group of custom services, and is adjusted to the individual needs of the recipient, as if "tailor-made". Thus, all of its elements are individually customized and individually negotiated at the same time [Dłubak 2006, p. 42].

It is worth mentioning that the levels of interest rates negotiated when the contract is concluded are lower, and thus more favorable than the traditional (alternative) forms of financing available to the enterprise. Their level depends on the type of cash pooling used, the financial condition of the party and the turnover volume generated.

3. The benefits of cash pooling services for banks and companies

Cash pooling is a very interesting financial service for enterprises operating as capital groups or holdings, especially for those which operate in several countries. The possibilities of its use can be extensive, because it is possible to arrange various options of balancing the accounts of companies in the group, such as [Tomala 2003, p. 2; Sierpińska and Jachna 2007, p. 221; *Home banking*… 2010]:

- cash pooling managed in one currency on all accounts;
- balancing of accounts held in different countries, different currencies, using cross rates;
- keeping aggregate accounts for branches in each country;
- using one account to balance the accounts kept in one country, in different currencies (e.g. current account in Polish zloty, auxiliary accounts for export operations in euro and U.S. dollars);
- centralized balancing of receipts in the various currencies in the aggregated accounts, separate for each currency;
- use of sub-pooling, creating groups of accounts balanced on many levels, within the country, business line, etc.

The benefits associated with the use of cash pooling services apply to both sides of the contract, the companies as well as the banks. The most important benefits for companies using this service include:

- effective management of cash within the group or within a single entity;
- possibility of central grouping and planning of receipts;
- automation of the operation of current liquidity management of the group;
- economies of scale – the fact that all companies can jointly negotiate, set credit limits and conditions, interest on debit and credit balances, gives them a better negotiating position in comparison with individual negotiations with the bank, resulting in a significant reduction of cost and maximization of interest revenue on the level of current financial services, which is attainable groupwise;
- reduction of the commission cost – as a result of mutual financing of related parties it is not necessary to incur the cost of bank charges that occur in the event of a bank granting loans to individual companies;
- retaining the financial autonomy of subsidiaries.

Offering of the cash pooling service can also give important advantages to the banks, despite the partial reduction of the margin they charge. These include first of all [*Home banking*… 2010]:

- reduction of the lending risk, because negative balances are compensated with the funds accumulated in other accounts;
- control a substantial part of the turnover on the customer's accounts, who, wanting to maximize the effect of cash pooling, will aggregate the current receipts and payments in it;
- limiting the outflow of the customer's temporary surplus of funds to other banks;
- ability to set the terms and conditions of cash pooling individually, so that they can at least partly cover the loss resulting from the so-called "spread", which is the difference between interest on loans and deposits;
- increasing the attractiveness of the service offering for current and future customers.

Therefore, offering the cash pooling service is also advantageous from the bank's perspective, although it must reduce its margin in comparison with the standard one, but it can also offset it by increasing turnover and reducing the risk level, which will eventually yield higher revenues.

4. The figures – a cash pooling example

The advantages of cash pooling for a group of companies are illustrated with an example based on the following assumptions:

- there are three companies: A, B and C, using cash pooling;
- interest on deposits is 3%;
- interest on bank overdrafts 6%;
- average annual balances on current accounts are shown in Table 2.

Table 1. The level of average annual balances in individual companies forming the capital group

Companies forming the capital group	Average annual balance in the account
Company A	+1,100,000 zloty
Company B	–300,000 zloty
Company C	–500,000 zloty

Source: Author's own research.

Before the cash pooling service was used, the interest result of the group had been as shown in Table 2.

Table 2. Interest of the capital group before the cash pooling service was used

Companies	Balance level	Interest
A	+1,100,000 zloty	+33,000 zloty
B	–300,000 zloty	–18,000 zloty
C	–500,000 zloty	–30,000 zloty
Result		–15,000 zloty

Source: Author's own research.

However, after the introduction of the cash pooling services the amount of interest paid by the group was smaller, as shown in Table 3.

Table 3. The amount of interest with cash pooling used by the group

Companies	Balance level	Interest
A	+1,100,000 zloty	----
B	–300,000 zloty	----
C	–500,000 zloty	----
Result	300,000 zloty	9,000 zloty

Source: Author's own research.

With the cash pooling service the group of companies attains measurable benefits, as shown in Table 4.

Table 4. The cash pooling service – benefits for the group

Before cash pooling	–15,000
Cash pooling	+9,000
Result	+24,000

Source: Author's own research.

The data in Table 4 indicate that previously the group incurred interest cost at the level of –15,000 zloty, whereas when they use the cash pooling service, they receive interest on deposits in the amount of 9,000 zloty. The beneficial effect will also be present even in the case of negative balance on the aggregated account of the group.

5. Tax aspects of the use of cash pooling in Poland

In Polish law there is no comprehensive regulation of cash pooling, which results in serious problems with the correct classification of activities performed within such an arrangement. The use of the cash pooling service raises many questions, related mostly to tax on civil law transactions. In the Act on taxation of civil law activities (art. 1.) defines the scope of transactions subject to this tax[1]. Article par. 1.1. 1 b) mentions a loan agreement which to some extent is similar to the cash pool arrangement as a taxable transaction. In accordance with Art. 729, Section 1 of the Civil Code: “through a loan contract the lender undertakes to provide the borrower with a specific amount of money or items identified only as to type, and the borrower undertakes to return the same amount of money or the same quantity of goods of the same type, and of the same quality”[2]. Many controversies surround the issue of whether the cash pool should be treated as a type of loan (and thus be subject to tax), or whether it should be included in another category of contracts. At this point, it should be added that the cash pool belongs to the category of so-called “innominate contracts”, which further complicates the issue.

However, the tax authorities follow the interpretations of individual Treasury Boards and hold the view that a qualification of a legal action and, in consequence, of its exposure to tax on civil law transactions is determined by the content rather than the name of the contract. In this sense, cash pooling as a way of managing available cash, even though it has certain features of a loan, does not satisfy all important criteria, because its purpose is to enable better and more effective financial management within the capital group [Szulikowski 2010].

From the bank’s point of view, cash pooling is a banking service, offered to customers to enhance the attractiveness of its offer, representing a worthwhile alternative to the traditional system of bank accounts, managed separately for certain companies belonging to the served capital group, i.e the bank’s customers. Cash pooling services performed by the bank under a signed agreement, as financial intermediation services are exempt from VAT tax and therefore these transactions are not subject to tax on civil law transactions, because pursuant to art. 2, par. 1, item 4 of the Act on civil law transactions, civil law transaction are not subject to this tax, if at least one party is subject to VAT or exempt from it [Wojciechowska 2009]. This position has been repeatedly confirmed by GUS (the Statistical Office), which classifies cash pooling as “other financial services” (financial intermediation services nec 65.23.10-00.00 PCGS) [*Klasyfikacje statystyczne* 2010].

This interpretation is important for bank customers using the cash pooling services, as they can manage their cash efficiently and, at the same time, without undue tax burdens. For banks it is also important, because they can offer this service on the market as an attractive alternative to customers, without exposing them to additional tax burden on civil law transactions.

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[1] Act of 9 September 2000 Tax on civil law transactions (consolidated text, based on OJ of Poland, of 2007, No 68, item 450, no. 176, item 1238 and of 2008. No. 209, item 1319).

[2] Act of 23 April 1964,- the Civil Code (OJ 1964 no. 16 item 93, as amended).

6. Conclusions

Cash pooling started several decades ago in the United States and Western Europe, as a result of the dynamic growth of capital groups around the world. This was because within capital groups there were companies in need of capital (in the growth phase), as well as companies with financial surpluses (in the mature phase). Cash flows between associated companies began to grow so much that the problem of margins charged by the banks became increasingly important, both during investing of surpluses in deposits, as well as financing of companies with loans. This type of financing model has been so ineffective from the point of view of capital groups that banks were forced to find an alternative solution to this situation in the form of new cash pooling services.

The development of cash pooling services in Poland follows the general trend in the world. It is used first of all by large groups of companies which include foreign companies. In the Polish banking system under the cash pooling service two types of this mechanism are offered – real cash pooling and notional cash pooling. The service is offered, among others, by these banks: PKO BP S.A., Kredyt Bank, Deutsche Bank Polska S.A., Citi Hanldowy, RBS Bank, ABN Amro Bank (Polska) S.A., Dresdner Bank Polska S.A. BPH, ING Bank Śląski, Fortis Bank S.A., Raiffeisen Bank S.A.

Cash pooling is a service beneficial to the banks, despite the decline in interest margins and thus the attainable profit. However, it causes a strong closer co-operation between the bank and the capital group. Therefore, the Bank gains a large customer comprised of many entities, and in addition to cash pooling, it can also offer them additional products. In addition, increasing competition between banks forces them to develop increasingly sophisticated products in response to customer needs. A capital group, i.e. a large customer with a large number of transactions and generating high volumes of turnover, provides banks with more opportunities to earn money from the commission received.

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CASH POOLING JAKO NOWOCZESNA USŁUGA ZARZĄDZANIA ŚRODKAMI PIENIĘŻNYMI W GRUPIE KAPITAŁOWEJ

Streszczenie: Spółki działające w grupie kapitałowej, ze względu na dużą ilość przepływów pieniężnych pomiędzy powiązanymi podmiotami, z których jedne wykazują nadwyżki a inne niedobory finansowe, wykorzystują nowoczesne usługi finansowe w celu optymalizacji efektu finansowego grupy. Jedną z takich usług jest *cash pooling*.