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CPE CREDIT INFO

Putting the SQUEEZE On Cash Management

By Larry Forman

Treasury executives, among their other duties, are tasked with handling their companies' cash management activities. That can include monitoring the organization's daily cash position, overseeing payments and collections, performing cash-flow forecasting, making decisions on short-term investments and managing banking relationships.

Cash management decisions are typically based on a number of elements that change over time, such as the cost of cash management services, prevailing interest rates and expected clearing times. Cash management personnel run the numbers to determine the most efficient solutions at a given time and then move on to other pressing responsibilities.

However, when the elements involved in these decisions change, cash management solutions need to be re-examined in light of the new circumstances. Given current economic conditions, now is one of those times.

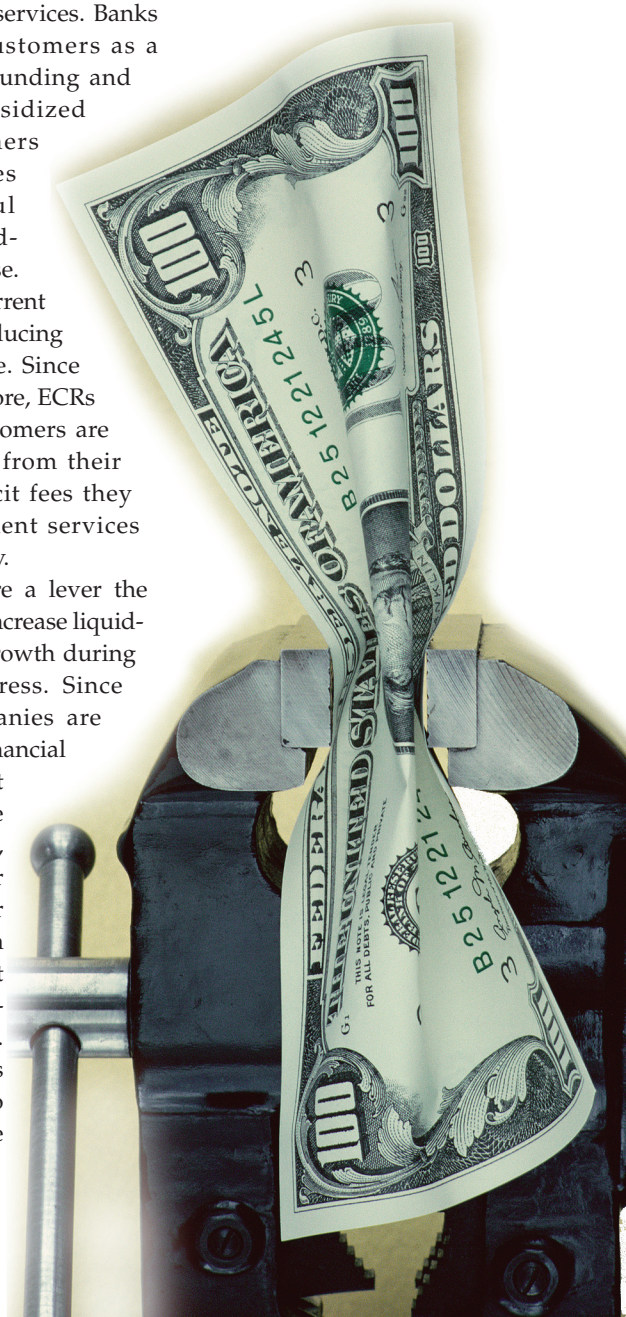
What do cash management services cost? Most companies pay for their cash management services through a combination of the value of the balances they maintain at their bank — calculated by the bank's earnings credit rate (ECR) — and explicit or hard-dollar fees to cover the remaining expense.

When interest rates are higher, companies that maintain large balances may pay low or no explicit fees for their cash management services. Banks value high-balance customers as a source of inexpensive funding and reward them with subsidized services. Even customers with smaller balances may see a meaningful reduction in their hard-dollar fees when rates rise.

Unfortunately, the current economic climate is producing a less welcome outcome. Since interest rates and, therefore, ECRs are ultra-low, bank customers are receiving little benefit from their balances and the explicit fees they pay for cash management services have increased noticeably.

Low interest rates are a lever the Federal Reserve uses to increase liquidity and help stimulate growth during economic stress. Since many companies are feeling the financial strain brought about by the slowdown, these higher hard-dollar fees for cash management services come at a particularly inopportune time. And when interest rates drop, they tend to do so quickly, intensifying the impact.

> The dynamics of cash management are changing, due to regulatory change, technological innovation and current uncertain economic conditions.



During the previous economic contraction in 2001, the federal funds target rate was lowered 200 basis points in two separate five-month periods. The rate fell from 6 percent to 4 percent between January and May 2001. Then, between May and November, the federal funds rate descended another 200 basis points to 2 percent.

In the current recession, the target rate dropped by 225 basis points in five months, declining from 4.25 percent in December 2007 to 2 percent in April 2008. By December 2008, rates had hit their current range of 0 to 25 basis points.

In response to an economic emergency, the Fed typically lowers rates quickly. However, when interest rates are raised, they generally increase in a slow and cautious manner because the Fed is fearful of stamping out the economic recovery it was fostering by lowering rates.

During times of economic stress, companies typically focus on finding ways to reduce expenses. Since balances are given a lower value and corporate customers end up paying higher hard-dollar fees for bank services, companies are further coaxed to consider how they can cut back on the use of cash management services. They may consider simplifying their bank account structure, dropping specific services or consolidating their cash management business to fewer providers.

Another option is to approach their current cash management providers to renegotiate bank compensation.

Aside from rising bank fees, lower interest rates can also influence an organization's cash management strategy as well as the tactics it considers using. In a higher interest rate environment, customers seek treasury solutions that deliver the traditional cash management benefits of speeding up collections and slowing down or optimally timing payments.

But when rates are low, the value of services that reduce float on collections or extend float on payments is severely diminished. Even before the rate plunged, changes brought about by Check 21 — the law designed to enable banks to handle more checks electronically to increase speed and efficiency — significantly reduced the float in the United States payment system.

In the present environment, bigger benefits are likely to be achieved by selecting solutions that create the most efficient processes. Reducing head count or eliminating redundant procedures will probably deliver more value than a small change in float would. These process improvements might be measured in terms of personnel hours saved or other processing costs eliminated.

Cash management services that deliver information continue to be important in any interest rate environment. During tough economic times — when cash flow may be more constricted — data that contribute to cash-flow forecasting is especially vital. As such, companies should think twice before considering any reductions in information reporting services.

From the Provider Perspective

In addition to fee pushback and requests for service reductions from customers, during a recession banks also experience declines in the volume of payments. According to the 2009 Ernst & Young Cash Management Services (CMS) Survey, which collects transaction data from virtually all of the major U.S. cash management providers, the recent past has proven no exception to that rule. Among survey participants are the 20 largest commercial banks that offer cash management services to wholesale customers.

For electronic payments, a comparison between January 2008 and January 2009 volumes of Fedwire — the real-time electronic transfer system operated by the Fed — revealed that the number of Fedwires declined by 7.5 percent.

Between January 2008 and January 2009, Clearing House Interbank Payments System (CHIPS) volume fell by 15 percent and book transfer volume declined by 7 percent. Overall, the number of same-day transactions was down about 9 percent. Automated clearing house (ACH) credit origination volume measured by the survey was down 2 percent.

Growth did occur in ACH debit volume, which grew at 6 percent as compared to a growth rate of 14 percent between January 2007 and January 2008. The slower rise of ACH debits continues to be fueled by the growth in Internet payments and the conversion of paper checks into electronic debits.

While electronic payment channels felt the pinch of the recession, paper payments were similarly impacted. The volume of general disbursement checks issued by banks' wholesale customers fell by 6 percent between January 2008 and January 2009, and controlled disbursement items fell 7 percent.

With fewer checks issued, it was not surprising that the number of items deposited also declined, by 9 percent. Check conversion into ACH debits also contributed to this drop. The volume of checks reconciled fell by 5 percent during the period, and the number of remittances received by retail lock boxes lessened by 6 percent.

Fewer payments produce less revenue for cash management providers. The survey has tracked the fee-equivalent revenue growth rate of the cash management business through the past two economic contractions, and the results clearly show that the painful combination of fewer transactions and low rates dramatically reduces revenue growth.

Annual revenue growth rates typically range between 5 percent and 7 percent when economic conditions are positive. During recessions, the overall revenue growth rate has historically been 3 percent or less.

And the Good News

A few bright spots reflect the theme of treasury professionals selecting solutions that create the most efficient processes. It's no coincidence that the E&Y CMS Survey measured the greatest growth in the products and services that change processes. Despite the economic downturn, purchasing cards have been one of the fastest-growing products for the past few years, measuring an 8-percent

increase in dollars spent between January 2008 and January 2009.

Customers are attracted to this paperless payment method because of the rich data collection surrounding the payments made by the card and the potential for easier reconciliation.

Another targeted product, payroll cards, also increased. The volume of active payroll cards grew by 25 percent during the January 2008 to January 2009 time frame, even as overall U.S. employment figures dropped.

Payroll cards reduce or eliminate the need for paper payroll checks and can be especially beneficial to businesses with high employee turnover or seasonal workers. These cards allow employees without traditional bank accounts to withdraw their salaries from ATMs and they can also be used at the point of purchase, mimicking debit cards.

Another relatively new product that has been growing at a rapid pace is remote deposit capture. This service combines the technology of small and comparatively inexpensive check scanners with the benefits of Check 21 to enable bank customers to deposit checks remotely from their locations into their bank accounts by sending check images to their banks.

Utilizing remote deposit helps to eliminate trips to the bank branch to make deposits and it can serve as a substitute for physically forwarding items to a lock box.

Remote deposit also helps some companies consolidate their banking relationships by eliminating the need for banks that serve only a limited depository role. The survey revealed a 40-percent increase in the volume of checks scanned remotely between January 2008 and January 2009.

Over the past decade, the cash management business has changed, with a greater percentage of the transactions and cash management providers' revenue coming from electronic and card products. In 1998, 27 percent of measured cash management revenue was produced by products and services that weren't paper-based. In the 2009 E&Y CMS Survey, electronic products — such as wire transfer, ACH and information reporting and purchasing cards — accounted for 42.5 percent of all revenue.

Though low rates and a sluggish economy may be inevitable for at least another few quarters, the pace of change in the payments landscape is not likely to slow down. It's anticipated that corporate treasury professionals will take advantage of this crisis to rethink their cash management strategy. The outcome is likely to accelerate the rate of change.

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