The Cash Management Companies Association

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ESTA's views on cash recirculation models
in the context of ongoing restructuration of central banks networks

The outsourcing of cash management functions respond to various rationales which reflect the role that National Central Banks (NCBs) wish to keep in the management of the cash cycle. Substantial cost reduction in cash management can be achieved through outsourcing as the cash management becomes more efficient and the market decides for demand in supply of cash.

The ongoing process of restructuring of NCBs' networks in various member states reinforces the need for an evolution of their functions and calls for revisiting cash recirculation models. The consequence is the increase of transport as the average distance increases with the reduction of NCBs offices, and of the related risk. However, a more efficient consequence would invite a rethink of the model for cash recirculation.

Cash is recurrently blamed for being costly, despite having the cheapest unit social cost of all payment instruments. The restructuring of the NCBs office network offers the opportunity to address two aspects of cash with a high potential for cost reduction:

- The first is in the improvement of the circulation model, the reduction of the repetition of tasks such as packing, unpacking, counting, sorting and testing as well as a reduction of transport costs;
- The second is the substantial potential for efficiency gains resulting from economies of scale, which can play a substantial role. The potential for economies of scales is very important as current non-NCB processing of cash is around 40% only, and this share tends to increase slowly.

Commercial banks, however, show an unambiguous desire to get out of the cash business, which they think is a cost they should avoid.[1] The CMC sector is best placed to fulfil its role of managing cash for society and its economy. There are however some obstacles to the increased role of CMCs in the cash cycle.

Different models of cash recirculation with specific roles for NCBs, banks and CMC companies have developed in different countries. Each of the EU/EEA countries has put in place their own model. Existing models can be summarised into 4 basic types with specific local idiosyncrasies. In each of these models, the responsibility of the commercial cash cycle operator varies from rather low in the "central NCB" model to very high in the "transfer" model. These models are evolving over time, particularly as the network of NCB office reduces.

Apart from the two common elements to each single model, which are that emission of banknotes and their destruction remain exclusive competence of the NCB (although in Norway, cash can be destroyed by non-NCB operators under strict control of the NCB), the respective involvement of the NCB and commercial operators can vary substantially.

[1] "*Single Euro Cash Area" (Seca) Framework*", European Payment Council 2016. There are a number of references to cash as a cost for banks, see however more specifically section 4.1 page 24 of the document.

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The various models have been reviewed in a joint EPC/ESTA note of 2009, updated in 2013. In short they are the following (ordered with a decreasing intensity of NCBs involvement):[2]

1. The centralised model where the NCB plays a pivotal role in the cash distribution cycle acting as primary warehouse through its networks. No NCB cash is held outside the premises of the NCB.

2. The public-private joint venture where a joint venture is established between the NCB and the professional cash handlers. Only the joint venture, and no longer the NCB, deals with all aspects of wholesale cash activities. Variations around this model include whether cash is held exclusively or not in the joint venture's vaults and whether BSR/NHTO schemes or any scheme of interest compensation exists to alleviate the cost of holding cash.

3. The delegation model where the NCB delegates some cash handlings activities, such as authentication and fitness checks. The specificity of each model within this category includes provisions for overnight interest relief for cash held outside NCBs, the existence of thresholds for NCB activities (quantities/denominations) and a clear roadmap with regards to what needs to be returned to the NCB

4. The transfer model where apart from issuing (and in most cases, destroying), the NCB is no longer present in the cash supply cycle. The drawback of this model is that cash processed and stored often remains in the balance sheet of each PSP/PCH; although in Norway and Sweden, where transfer models are in place, balance sheet relief exists. The NCB's role is reduced to withdrawal of unfit cash and issuing new cash. The NCB transacts with approved operators acting as cash depots. The model allows for direct exchange of cash surpluses within CMCs or between PSPs which may increase velocity of cash (and therefore reduce the amount of cash in vaults).

The cash cycle can be made more effective by promoting circulation outside the NCBs networks and reducing transport to and from NCBs branches. It notably reduces duplicate/multiple counting and verification processes between each separate step of the cash cycle and reduces the volume of unsorted cash to the NCB. It also allows for a significant larger window of operations since delivery of cash to NCBs can be severely constrained by opening hours of NCBs offices, which can involve a cost to cash handlers if they have to keep cash overnight that they could not deliver on time to the NCB office. Flexibility in managing cash is increased, albeit with strict controls to ensure the security of the cycle and the trust of customers.

The EU/EEA CMC sector is confronted with the diversity of regulatory/prudential cultures existing in various EU Member states: it results that what is possible in one country without a PSP requires the registration as PSP in another, while a third one might simply reject the mere idea of a CMC registering as PSP. The diversity of these national cash management cultures means that the CMC market is fragmented within the EU.

[2] For a complete description f the model, cf. the ESTA EPC document "*Improving the efficiency of the handling of cash– Cash Cycle Models*", 13 December 2013

ESTA's ideal cash re-circulation model

The ideal re-circulation model for cash management companies is one that needs to take into account a number of essential characteristics to ensure a smooth and efficient cash cycle and reduce the cost for operators and users.

- ESTA appreciates that all countries and their NCBs, whether in the Eurozone or not, will not adopt the same recirculation model. However some convergence is desirable. Long term visibility on the cash recirculation model is indispensable for planning the relevant investments that will make cash processing more efficient. Clarity in the role that NCBs want to play in cash is not only desirable, but also indispensable;

- Transport is less and less the core activity of the CMC industry. A business environment that allows for less transport and more cash management by the industry provides for a smoother and more efficient cash cycle. In a context where the number of NCB offices is reducing, less transport is only compatible with more cash management by non-NCB operators, allowing for shorter cycles and reductions of repetition of processes such as counting, packing and unpacking etc. It is the core business of the cash industry to take greater responsibility in the management of cash and the operation of its cycle;

- The business environment must allow for flexibility in the way cash is managed, together with efficient supervision and controls to ensure that customers' funds are managed safely and reliably. Most countries request a segregation of funds by customers or by banks in the vaults of CMCs, which prevents CMCs to address in an efficient way surpluses and needs of cash between customers. Other Member states have no objections to the mixing of funds for a short period of time to allow for a flexible management of needs and surpluses. The extreme opposite is the requirement for registration as a PSP under the PSD with an ad-hoc level of own funds (which however does not provide a European passport[3]);

- Whilst prudential supervision is key to the process, it should not lead to impose excessive own funds requirements which are costly and constitute a serious barrier to access to the market for incumbents or new entrants. Prudential requirements should not be excessive in relation to the effective limited risks that flexible cash management might represent;

- ESTA understands that the diversity of supervisory rules in Member states reflect possible differences in the perception of risks. However, since risk is rather homogenous, better convergence between Member States on the regulatory environment in which CMCs operate should be envisaged;

- Finally, key to the business environment is the existence of mechanisms allowing funds to be held off balance sheet by CMCs on behalf of customers or central banks and with no costs for the CMCs. Different systems have been developed and are in place in Member States such as NTHO and interest compensation schemes. From an ESTA point of view, a very effective and efficient system would be based on the following principles:

    - The system would be based on a contractual scheme with clear and objective requirements based on operational, financial and security related criteria;

[3] The level of own funds requirement under the PSD for a European passport is incommensurate both with the capacities of CMCs and with the effective level of risk

- While “utility”-type solutions, possibly involving public-private structures may appear superficially attractive, they stifle competition and innovation, leading to higher costs for all stakeholders. Furthermore once formed they are very difficult to dissolve. The scheme to be implemented must allow for a multiplicity of operators and fair competition. One of the roles of the NCB and/or supervisory authorities is to ensure effective competition and that the cost to commercial cash handlers remains reasonable. Models existing in some Nordic countries have led to very high charges to cash handlers which may generate uncertainty with regards to their long term sustainability;
- The scheme for recirculation on behalf of NCBs should be opened to members who have a network that allows them to operate without limitation throughout the territory of the country;
- Recirculation would be conducted on behalf of the NCB and based on strict criteria for checking and controlling notes;
- The question of whether CIT/CMCs conducting recirculation of notes on behalf of the NCB should be backed or not by a commercial bank or through alternative prudential criteria is one to be decided by national supervisory authorities;
- Notes held in CIT/CMC vaults on behalf of the NCB should not constitute assets to the CIT/CMC companies and should not be entered in the balance sheet of the company. How this is done is also a matter for national supervisory authorities to decide, either through a balance sheet relief mechanism or by considering, as is the case in the UK for example, that notes stored in vaults are “*not deemed in circulation*”.

ESTA calls for such a framework based on this scheme to be envisaged at EU level, which could be adapted to reflect specific local/domestic environments and cash management culture.
