

# Payroll Tribune

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## Shields Up Part II

As many of you know, I don't usually publish a Payroll Tribune in February. Most payroll service bureaus are too busy converting new customers, verifying employee data and tax information, getting out year-end statements and tax returns, and preparing and billing for W-2's and 1099.

By the way, fees charged for W-2's and 1099's this year averaged in the \$3.50 to \$4.25 range. Bureaus with 700 accounts should bill plus or minus \$75,000 in fees; those with 1,000 accounts \$100,000; 1,700 accounts \$230,000. What's in your wallet?!

You can read my first article called Shields Up at our website ([www.henshawvierra.com](http://www.henshawvierra.com)). In that dower article I said that the financial system will need to remove the bad credits from the market and come down harshly on the brokers, rating agencies, investment bankers and their lawyers who abused the system, to fully restore trust.

The fourth quarter saw the credit freeze continue. Billions of dollars, something like \$450 billion in asset backed commercial paper could not be rolled over. The money market funds, which held much of it, did not re-new their purchases and moved to other short term investments. Unfortunately for them, they still hold hundreds of billions of dollars worth of the paper which is due to come due in the first and second quarters of this year. With the value of the assets and now the cash flow from those assets supported by that commercial paper in question, money market funds could actually have to think the unthinkable, and break the "never break a buck" rule. That rule says that money market mutual fund shares which are sold at \$1 a share must always be paid back to the customer for \$1 a share. Right now, Wall Street says that this is a remote possibility.

The money market funds, the Fed, the commercial and investment banks understand that this must not happen. The Fed has said several times that they will provide all the liquidity the system needs. and they have. That means that if the assets backing these various financial interests can not be valued by a market that does not know how bad the underwriting was, how much was not told them, how much borrower and maker fraud there was, the Fed will take the paper against loans it is willing to provide to the commercial banks. The Secretary of the Treasury tried to get the banks who issued the paper to "buy" it back from their customers (ie. Money market funds, pension funds, insurance companies, other banks, etc) so that they could make them whole while the Fed would back up the banks. The banks could not agree on a \$100 billion pool to support each other, so you have seen them take their write offs individually.

Most of the major banks have begun to take write downs and charge off bad loans. Most investment management firms began to write off bad asset-backed loans and related financial derivatives. Some have "fired" their CEO's. Some have found new capital in foreign lands. The fourth quarter reporting period, during the first quarter of 2008 will see more: more revelations of bad credits, more write downs, more CEO's getting "fired", and more volatility in the markets. Believe it or not, this is actually good. The problems are being recognized and the first steps to remediation are being taken. There are lots of questions about whether enough is being done quickly enough, and only time will tell.

## Shields Up (continued)

### Will we have a recession?

When central banks provide this much support, they are not only doing the right thing, they are doing it because the situation is very serious, and they have little choice.

If banks do not trust each other to loan each other money backed by their own bank assets, you can bet that they will not lend funds to businesses and consumers. If businesses and consumers do not have access to liquidity and working capital, they will cut back on spending for job creation, new capital goods, expansion. That rose, by any other name, is a recession. If it is not solved soon, that recession will move into stagflation. This recession will have strong elements of stagflation too since all this Fed liquidity will result in a flood of dollars in the financial system.

### *So why is this important to your service bureau?*

It is important because it will affect your customers and the number of checks they run. It is important because it will affect the credit worthiness of your customer and of the investment securities you use in managing your customer tax deposit accounts. It is important because it will affect the financial soundness of the banks, clearing houses, and brokerage houses you use to transact your day to day business.

### Go Bears!

I am not a long term bear. The market has allowed clever, sloppy, greedy people and institutions to abuse the system. Blame runs from borrowers (statistics show that if a loan goes bad within one year, 75% of the time fraud was involved), to commissioned brokers, to appraisers, to underwriters, to syndicating bankers and their lawyers, to the rating agencies, to the investors who did no due diligence in buying assets they did not check and in some cases did not bother to understand. All will feel the pain of this bear market, but so, unfortunately

will you and I. We all, except some of the perps who got out early, will be a little sadder, wiser, and poorer.

But, read on, to see how you can reduce your risks in this volatile market.

### Steps to consider to Reduce Risks in this Environment.

1. **Know your customer.**
2. **Develop, document, and use risk averse money management practices**
3. **Know your banker, ACH clearing agent, broker**
4. **Understand the securities you hold for your company and for your client fiduciary accounts.**

You can take steps to manage the risk to your service bureau in this or any market. We have been writing about some of these measures for years. We have helped many of our clients review and implement these controls since we began our business in the mid 1990's.

## Today, you need to resolve to actively manage credit risk in your bureau.

A bureau must deal with credit risk coming from the customers it has, the transactions it under takes for them, and in the assets it uses to invest customer fiduciary funds and the bureau's own investments and working capital.

Customers pose at least two forms of credit risk: the risk that they can not pay their bill for your services, and the risk that they do not have sufficient funds to make good funds transfers undertaken by the bureau on their behalf.

Most bureaus today manage their Accounts Receivable risk easily by debiting their customer's account at the time a service is performed and invoice generated. However, not all bureaus use enough risk control measures to control funds transfer risk.

Control of that risk, I believe, actually starts with the bank or transfer agent the bureau uses. A good transfer agent will help the bureau set up the documentation needed for each customer and for each employee of each customer, and will help keep it current. A good transfer agent will help the bureau set up funds authorization and transfer practices which reduce the possibility of bureau error and increase the probability that the bureau customer will have good funds sufficient enough and timely enough to insure a sound, auditable, controlled process takes place. If you don't think risk controls are important, google Societe General to see how lax controls cost them \$7 billion in losses over a weekend.

## Shields Up (continued)

Bureaus should control their risk by “knowing their customer”. References are good. FICO scores are helpful. Credit reports are helpful too. Change your customer agreements to allow you to get this information on the customer before the first payroll and from time to time in the future. I know, competitive pressures make these suggestions “ridiculous and will kill deals”. That is exactly what the loan brokers and investment bankers said about the home loans they were slamming together. So here is another suggestion, watch how the customer reacts to your rules for the prudent management of cash flows. Tell them you transfer “good, confirmed” funds only. Tell them you have a zero tolerance for “not-sufficient-funds”. Tell them you require them to notify you in writing of any changes in their or in their employees’ funds transfer requirements, before you undertake any transfers on their behalf.

All funds transfers should require double signatures within the bureau. Customer liability requirements and funds transfers should be forecasted by the operating system. Actual transfer request documents should be checked and signed off on by the bureau preparers. These documents should be reviewed by operations and given to a second employee in the bureaus fund transfer group. That group should confirm the amounts and the actual instructions, before wiring instructions to the clearing banks. The transfer employee should then review the clearing bank’s confirmation and immediately report any indication of non-sufficient funds or transfer failure to operations.

The most important process a bureau can conduct is to balance their fiduciary and other bank accounts daily. This is mandatory for a serious bureau. Daily balancing will alert you to problems, immediately, while you still have time to react and correct them.

### Treasury Management in Troubled Times

We have talked about treasury management in past Payroll Tribunes. Treasury management is mandatory in all markets, but absolutely mandatory in a bear market.

1. You must do your own due diligence on any security your buy even if it is only an overnight investment.
2. Whether you invest your own funds or use a broker or use an investment manager, write an investment policy that includes the type of securities you can invest in, where the securities will be held, and what steps you require from yourself and/or a third party in doing due diligence on the credit quality of an investment.
3. Start with the concept that if you do not understand the investment, do not invest in it.
4. Another good thing to remember is to buy quality and do not chase yield in a bear market.
5. Make the broker send you an annual report, prospectus, analyst review on any paper they sell you. Put a credit file together. I always did that even when I was investing millions of dollars daily for the bank investment portfolios I managed.
6. Don’t use brokers and managers who think that this is a waste of time. When one of their investments fails or their money market fund “breaks a buck”, they are not going to be the one to pay you what you owe the IRS tomorrow on behalf of your customers. You can manage your risks in this market. You should do it before you need to. We can help. Your clearing bank or agent can help. Some good brokers can help. Your auditor can help. It is up to you to “get ‘er done”.

## Henshaw Vierra Management Counsel LLC

Our firm is one which helps our clients answer general questions about how they should better run their business and manage their investment in their payroll service bureau. We help them analyze their business. We can because we have been managers ourselves and because we have experience in dealing with payroll service bureaus around the country for over fifteen years. We particularly work with clients to help them plan their futures. That includes:

\*building business plans    \*creating budgets    \*planning and managing system conversion

\*managing change    \*surveying their customers’ opinions

\*helping owners structure and negotiate the terms of sale of their business or the purchase of more customers from another company

Call us, in confidence, with your questions at 510-749-3225 or [guy@henshawvierra.com](mailto:guy@henshawvierra.com).