The changing treasury and the journey towards centralization

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Prior to July 2007, we had unprecedented global growth for almost a decade. This was largely driven by the strong performance of the emerging markets especially Brazil, Russia, India and China (Bric countries). This global growth combined with low interest rates in the United States led to low credit spreads and significant liquidity in the market.

Since then, the global financial environment has taken a plunge towards the worst starting with the sub-prime crisis in the United States housing market, high commodity prices especially oil, and near failures of financial institutions. In this environment, the corporate attitude towards liquidity has changed significantly. The reduced access to capital markets has worried many companies about liquidity to weather the current crisis. There is far more focus within most companies on three most important things that are always on the corporate treasurers' mind – liquidity, liquidity and liquidity.

Typically, the treasurer has four sources of capital – the existing cash balance, internally generated cash flow, bank credit lines and capital markets. With the latter two becoming difficult to access due to external market conditions, the treasurer needs to focus on the first two sources. The easy access to internal cash and cash flow allows the treasurer to control liquidity deployment per the business needs. For companies with multiple business units and geographically dispersed business, the sources and uses of cash flow are in multiple locations with varying degree of regulations. By building liquidity infrastructure that connects all these locations, the treasurer can use this cash resource efficiently and deploy cash wherever it is needed. The cash generated or used in various locations comes in various forms i.e. currencies. To ensure that these currencies can be converted from one form to another, the treasurer needs to have the ability to access foreign exchange markets and make the liquidity truly fungible.

All this is feasible, when the treasury organisation is centralised and the legal entities around the world are focused on driving business performance without being concerned about liquidity and foreign exchange risks. In this context, what is an ideal structure of treasury organisation that helps corporation tackle these risks?

HUB AND SPOKE STRUCTURE

The treasury structure that helps to control the cash and manage the risks most efficiently is hub and spoke structure. The centralised treasury is a hub or reservoir where the policies are drafted, all the cash and cash flow is concentrated, and is aligned with global finance strategy. However, due to the different working time zones in Asia Pacific, Europe and Middle East and Americas, the regional treasury centers (RTC) are setup as spokes of the treasury center (hub) that provides service to the business in each of the three working time zones. The guiding principles for these centers can be summarised in five main pillars.

PILLARS OF CENTRALISED TREASURY OPERATIONS

Governance: This area covers the policies, operating procedures and the control framework for operations in treasury and business units. The policies should be approved by the board, should be easy to understand and be readily available to all the company employees. The operating procedures are guiding framework for all treasury employees to ensure consistent operations at hub and spokes that meet all regulatory requirements. The control framework ensures segregation of duties with clearly defined roles of front, middle and back office. The compliance with Sarbanes-Oxley requirements should be a natural outcome of the existing governance, if done right to begin with.

Cash management: This function is responsible to build the liquidity infrastructure by working closely with banks to mobilise cash to and from the hub using techniques such as cash sweeping and cash pooling. The automation greatly improves visibility and control of cash within company. The concentrated cash allows it to be invested centrally to yield higher interest income.

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This function also needs to work closely with working capital teams (both accounts payable and accounts receivable) to integrate daily liquidity planning with working capital.

Risk management: This function deals primarily with mitigating risks due to market factors such as foreign exchange, interest rates, and commodity using various hedging techniques from the market. It also needs to monitor the counterparty credit risks and setting limits on exposure for each financial institution based on their tier 1 capital and credit rating.

Subsidiary funding and repatriation: This area works closely with tax to determine the capital structure of subsidiaries. It is also responsible for funding subsidiaries through medium/long term inter-company loans and planning annual repatriation of subsidiary profits. It works with legal to draft board resolutions and loan agreements between the treasury center and subsidiary for all the inter-company funding.

Systems and technology: This pillar is responsible for the treasury management system to record and initiate transactions in cash management, inter-company finance and foreign exchange. It also needs to ensure that the treasury system is integrated seamlessly with bank systems and company wide ERP system and provide automation in improving treasury productivity and decreasing manual errors.

JOURNEY TO A BEST-IN-CLASS TREASURY CENTER

Each company will be at a different stage of moving from decentralised to centralised model of treasury operations. The centralisation process begins with a plan, a roadmap and most importantly senior management buy-in. The three stages of centralisation are as follows:

Visualisation: A single view of cash

Visibility of global cash positions starts with setting up regional treasury centers in regions with a clear mandate to reduce the number of banking relationships and to rationalise bank accounts. Then using technology solutions and SWIFT messaging, treasury center obtains the bank balance information from all the banks in a single portal. This stage requires internal education and subsequent buy-ins from business finance staff that used to be responsible for banking till then. The time taken to achieve complete real time visibility depends upon the complexity of business. This initial stage allows the treasury center to start taking control of the corporate cash.

Mobilisation: Centralising cash control

Once the treasury center has the visibility then it can mobilise and concentrate cash in a tax efficient jurisdiction using sweeping and pooling techniques offered by global banks. This stage allows the treasury center to control cash, increase yields on excess cash and improve control on foreign exchange exposure. Most importantly, it allows the company to operate with lower cash balances and reduces fraud due to just in time funding by eliminating cash leakage due to inefficiencies. With higher control on cash, it can be deployed wherever the funds are needed and this decreases reliance on local bank credit lines to fund growth in a particular location.

The treasury center can also help control the external payments from various locations in the company by centralising the activity in payment factory or shared service centers. This allows standardisation of process for disbursements and makes cash forecasting and cash positioning for liquidity far more robust.

Optimisation: Pooling and investments

The treasury center can reduce the number of cash and FX transactions by using internal netting of all inter-company transactions. Similarly, companies can centralise sales process using re-invoicing center. This allows easier control on liquidity through leading and lagging of inter-company trade payments that are less restrictive than capital account cross border transactions. Both these solutions allow foreign exchange exposure to be concentrated at the netting center or re-invoicing center and thus make it easier to forecast and hedge FX exposures. Finally, the company can set up in-house banks that allow payment on behalf of subsidiaries, inter-company FX contracts, and booked rather than physical transactions by setting up virtual accounts with internal bank.

All this is currently feasible due to advances in technology and banking networks across the globe. The regulatory environment in certain emerging markets are still an obstacle to free movement of funds on capital account but this is evolving in most countries as they embrace globalisation.

The companies that have embraced treasury centralisation have reaped tremendous rewards and competitive advantage resulting in increased shareholder value. It involves closer look at the internal processes and setting the company on a path from regional treasury centre to in-house bank. This journey can take few years to complete but there are tools, bank service providers, and technology to help achieve the best in class state or "Nirvana" in the form of in-house bank. Lest we forget, the journey is the reward! ■

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