



GLOBAL COMPANIES CAN SAVE THEMSELVES A FORTUNE BY SETTING UP IN-HOUSE BANKS AND PAYMENT FACTORIES, SAYS **ROBERT WENNERSTRÖM** OF TREMA.

# BANKING ON YOUR OWN BUSINESS



According to a 2002 report by Killen & Associates, a company with \$1bn in revenues can waste as much as \$32m a year through inefficient working capital and processing functions. It is not surprising, therefore, that firms are increasingly focusing on reducing idle cash and rationalising processes, with many adopting payment factories and in-house banks to achieve just that. The same report suggests that, by creating an in-house bank, companies globally could save up to \$260bn, \$160bn of which would come from reduced payment processing costs, foreign exchange (FX) costs and settling payments more efficiently.

With such strong cost benefits, the business case for building in-house banks and payment factories is clear. However, increasingly, these cost drivers are being supplemented by a growing need for transparency and control, particularly in light of tighter regulations such as Sarbanes-Oxley and ever more complicated accounting requirements, including IAS 39.

Let's examine the business drivers compelling corporates to take a more serious look at in-house banks and payment factories, the technology required to successfully create such entities and the

resultant benefits. For example, pharmaceutical company Merck & Co recently realised savings of \$3.1m following the implementation of a payment factory to work alongside its existing in-house bank (see box on page 28).

This proves unequivocally that although payment factories and in-house banks deliver indisputable standalone benefits, it is the combination of the two that really delivers the goods in treasury.

**HOW WE GOT WHERE WE ARE TODAY.** The evolution of the treasury operation has been a gradual process. The first step in the expansion of the activities of central treasury and the development of the in-house banking model took place when subsidiaries began approaching central treasury, as opposed to external banks, for funding and foreign currency hedging of their commercial activities. The second step involved central treasury acting as a netting centre for commercial payments to reduce the cost of inter-company payables and receivables. This was facilitated by the use of multi-lateral netting technology, which allowed treasury to net all of a company's divisions' payables and receivables in different currencies to one net payment or receipt, often in the base currency of the

entity, removing the need for expensive external FX transactions. This was central treasury's first foray into commercial payables and receivables and was closely followed by the centralisation of foreign currency third-party payments.

Whereas treasury drove the in-house banking model, the payment factory was often developed as part of a shared service centre approach or driven by IT. It also involved the consolidation and streamlining of the whole payment process through a centralised unit, minimising the number of bank interfaces required, reducing IT costs and placing the company in a better position to negotiate lower payment fees with the banks.

Although in-house banks and payment factories enable a reduction in banking relationships, bank accounts and external payments, it is the combination of the two that delivers the most significant benefits. By routing third-party payments and inter-company payables and receivables through the combination of the in-house bank and payment factory and settling with the central treasury in its own currency, expensive cross-border payments are transferred into domestic payments, significantly reducing costs.

**THE DRIVERS.** Reducing overheads has become increasingly high on the agenda for treasuries over recent years. Whereas previously a company could take positions in the market and actually make money, such activity has been seriously restricted in recent years following a growing number of corporate scandals, which have highlighted the large exposures and positions being taken by the treasury. The ability to internalise previously external activity and provide services to subsidiaries as part of the in-house banking model are now enabling central treasury to reposition itself as a service centre and remove the need for outsourcing.

The increasing, and now regulatory requirement for transparency of information is also driving the co-ordination of responsibilities and consistency in processes and systems to deliver visibility across an organisation. The function of the treasury department in a multinational corporate is extremely complex and, where the organisation has grown up through acquisition, it can often involve disparate systems and processes, seriously impeding visibility and control.

**THE BENEFITS.** Aside from the business drivers, it is advances in technology that have really put in-house banking and payment factories in the grasp of the corporate. Developments over recent years have enabled treasurers to collate cashflow forecasts from global subsidiaries on a real-time basis to consolidate the organisation's funding and FX position. This enables central treasury to know, on a company-wide level, what its positions are, what it owes and the extent of its expected receivables. The crux of this is more accurate planning and matching of funding needs, helping treasury to optimise the organisation's working capital and keep idle cash to a minimum. By integrating this function, in terms of organisational structure, personnel and technology with an in-house banking model, treasury has total control and visibility of where its cash is coming from and where it needs to be on a global basis.

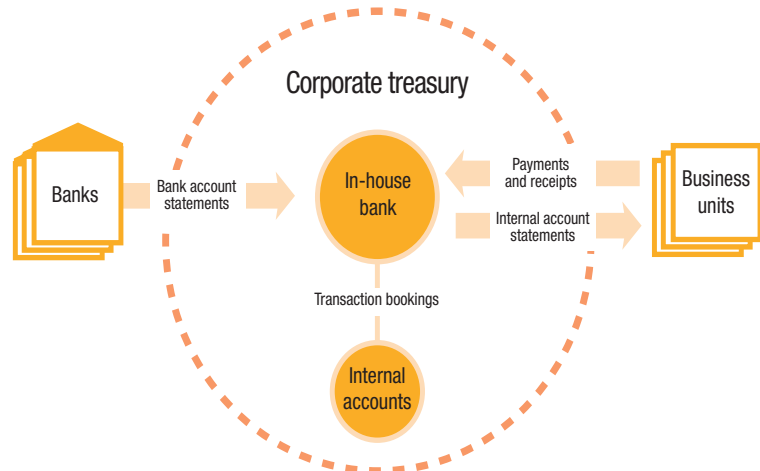
This real-time insight into all inter-company relationships and in-house bank balances, gives central treasury added visibility. It can tally in-house bank balances with the total funding position for the

### The technology behind in-house banking

The right technology is imperative to support the in-house banking/payment factory structure. Companies need a centralised platform that can provide a hub between the in-house bank/payment factory at central treasury, enterprise resource planning (ERP) and accounts payable/receivable systems at the subsidiary, and the external banks. This must be flexible enough to support variations on the set-up. From a technology selection and implementation perspective, there are a range of variables to consider:

- A company may have either centralised or decentralised responsibility for accounts payable/receivable processing. The technology therefore needs to support both a shared service centre approach and allow individual subsidiaries to enter or import approval of their payments. This is often achieved using browser-based access to the central system.
- The in-house bank structure is also governed by the legal and tax regulations of the country in which the in-house bank resides and the technology needs to be able to support these variations.
- The technology needs to be flexible in the creation of banking relationships, as firms may need to move between banks as their strategy changes and as banks' products/services change. This enables companies to achieve a greater degree of bank independency.
- Depending on a variety of factors, such as the company's size and how centralised or decentralised its structure is, the implementation project that best suits an organisation may vary. It is therefore important for the technology to be flexible enough to support a range of different implementation plans and meet the needs of a variety of companies.

### Full in-house bank services to business units



Source: Trema

## 'AN IN-HOUSE BANK NEEDS TO BE COST-EFFECTIVE, SO SIMPLY EMPLOYING MORE STAFF TO MEET THIS NEED IS NOT THE ANSWER'

subsidiary, for example, short to long-term lending and borrowing, capital injections, enabling it to set and follow-up the credit limits on the funding of its subsidiaries.

All of this visibility translates into added control and a company-wide overview of inter-company funding and working capital management. The benefits of control and efficiency in working capital management are straightforward. The less idle cash you have, the more you can invest back into driving your business forward.

**VIEWED FROM THE OUTSIDE.** For an in-house bank to be successful, it needs to show value to its internal 'clients' by offering lower costs, quicker service and fewer errors than an external bank. However, it also needs to be cost-effective, so simply employing more staff to meet this need is not the answer. Central treasury needs to be able to deliver information to its subsidiaries fast. By rolling out web-based technology, the subsidiaries can remain self-sufficient, accessing the information they need quickly and efficiently, removing the need for additional headcount and protecting central treasury's position as the keeper of the information.

Web-based technology also enables subsidiaries to enter, approve and monitor payments, view in-house account statements and integrate local accounts payable/receivable systems with central

treasury. This is instrumental to delivering control and visibility company-wide and making the benefits of in-house banking evident to the subsidiaries.

**CHANGING ROLES.** In centralising functions and expertise within the treasury, the role of the financial officer naturally changes, both at global and subsidiary levels. Local finance officers at worldwide subsidiaries may have previously acted as 'local treasurers', managing local banks and tracking currency interest rates, for example. By having concentrated expertise in this area at the central treasury level, and reducing local banking relationships, they only need to liaise with their in-house bank.

**NO PAIN, NO GAIN.** Implementing an in-house bank/payment factory will impact the organisation from central treasury down to the subsidiary level. That said, the cost and efficiency gains speak for themselves, particularly as the average estimated time to realise return on investment (ROI) on a project is around a year.

An often ignored but important by-product of an in-house bank is the ability of the CFOs to focus on the jobs they were employed to do. By enabling CFOs to bank via the internal treasury, they can focus on their core role: budgeting, financial reporting and, most fundamental for a corporation, making a profit on the goods or services they sell. In short, the group as a whole can go back to the basics of focusing on how to make its business successful and profitable – and that's value you can take to the bank.

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### Setting up a payment factory

Global research and development company Merck & Co, also known as Merck, Sharp & Dohme (MSD), has recently completed the implementation of a payment factory to interface with its in-house bank. MSD's goal was to turn expensive foreign payments into relatively inexpensive locally cleared domestic payments – not a simple task for an organisation with more than 100 affiliates worldwide.

By 2000, MSD had made progress in the centralisation of European cash management with the creation of a euro pool and was deploying Trema's cash management solution to manage the inter-company netting process. However, the group needed more.

In implementing a payment factory, MSD wanted to achieve a standardised, simple global business process for payments, collections and cash management, resulting in greater visibility and better management of financial flows and the related foreign exchange (FX) business.

By integrating the payment factory with

its existing in-house bank, MSD was able to extend the use of existing technology, not only to manage inter-company netting for all affiliates, but also centralise all cash, financing and pooling activities. This enabled cross-border payments to be processed centrally for 28 affiliates, plus some domestic payments. Inter-company loans, European FX and investment activity were also managed through the system. This centralised approach enabled MSD to extract and analyse information for cashflow forecasting.

The next step was to build a single standard interface between the cash management system, accounts payable and the general ledger, which enabled the solution to be used as the cash management engine to implement the payment factory. The objective in establishing a payment factory was to eliminate the bank's cross-border payment charges and FX spread charges by making 'on behalf of' payments. By extracting payments from the enterprise resource

planning (ERP) system, loading them into Trema's solution and then forwarding them to Citibank for processing as mass payments, MSD has been able to achieve this.

The creation of a payment factory that was tightly integrated with its in-house bank has realised significant benefits. Reconciliation has been reduced through the introduction of a standardised and automated inter-company reconciliation process, and manual reconciliation of open invoices and bank statements is no longer required. A payment interface has removed the need for labour intensive processing and recording of payments, while central processing of payments has enabled a reduction in banking fees. Short-term cash is consolidated and returns improved. In 2003, MSD's treasury and cash management project achieved total savings of \$7.5m, of which \$3.1m arose from the payment factory – savings which will rise as MSD continues to rollout to other operations.