



# Finding real value

DAVID SWANN, GROUP TREASURER OF BAT TALKS TO PETER WILLIAMS ABOUT THE COMPANY'S IN-HOUSE TREASURY SERVICE CENTRE (TSC).



## Executive summary

While the upfront financial case for an in-house bank may be relatively modest, the real value lies in the service it can offer the rest of the organisation.

**B**AT is one of the world's most international groups. In 2006 the group had turnover of £25.1bn and profit before tax of £2.7bn. It has several years' experience of running an in-house banking facility. When BAT first started the project to create the unit it was called the in-house bank (IHB). However Group Treasurer David Swann decided to change the name to the Treasury Service Centre (TSC).

He said: "It's semantics but I think Treasury Service Centre better describes what it does. In most corporates there is a suspicion that a bank is there to make money from you – even when it's managed in-house. The Treasury Service Centre is there primarily to provide a service and support the business and not just do the dealing."

Whatever the title of the unit, David Swann set up the TSC

for several reasons. Most obviously there are good financial reasons. However the upfront financial case for an IHB/TSC is relatively modest compared to the size and volume of the foreign exchange (FX) exposures and cash/liquidity handling for which the unit is responsible.

But a TSC is not just about a return on investment. Swann says that it provides benefits in other areas. The key benefit of a TSC is that it provides consolidation and visibility of cashflows and risk – the raw materials of good treasury management.

He says the TSC in its basest form acts like a counterparty bank to the company's operating units. He adds that while it looks like a bank the TSC is more than that because it is offering services to the company.

David Swann said: "Consolidation of the group's in-country treasury dealing is important to us because that gives us visibility of our overall banking business. And then we can better target that business on our relationship banks. As opposed to it going to a myriad of local banks with which we do not have a global relationship with."

That visibility of dealing business is important because it gives the company better control and allows the treasurer to be an informed influence over who gets the business.

The TSC allows the treasury department to look at the basic cashflows in the business. This provides a better picture which allows the treasury department to start netting off exposures. David Swann said: "This goes beyond how a bank does business with us." So BAT is able to consolidate activity and exposures and therefore it provides BAT with the ability where it can deal the net exposure out in the market, whether that is cash, FX or any other treasury activity.

**FINANCIAL SAVINGS** In setting up an IHB/TSC the most headline savings are on the spreads in terms of buying and selling FX and short-term borrowings and investment of cash. But they are relatively modest compared to the savings an entity can make by netting off the gross exposures and then managing the net position compared with managing gross exposures. David Swann said: "If those gross exposures are being managed at an operating company level typically they are being hedged at different times by different people. And, in the long run, corporates typically lose out to the banks when it comes to accessing the FX markets. By simply reducing the amount of FX business we do – by netting down gross exposures – we have less opportunity to be exposed to large fluctuations in FX and interest rates."



**CREATING A VIRTUAL TSC** BAT has an objective to create a virtual TSC. BAT is one of the world's largest companies with operations spread across 180 countries. BAT offices are open somewhere in the world all day every day. So therefore it genuinely needs a round the clock operation. At the moment this is provided by the TSC having a presence in London and in Singapore with a dealing room in both locations. There are two ways of progressing with a virtual TSC. One way to move ahead would be to create a single physical location which is open 24 hours a day. The alternative is to have centres in different time zones. The latter is the approach which BAT has adopted. The BAT Singapore dealing room covers Asia while the London operation covers Europe and Africa, and North and South America. David Swann says BAT is currently considering setting up a dealing room/TSC to cover the Americas region, although he says the argument for such a move is "less compelling".

When creating the TSC BAT has tried to make the experience appear as similar as possible for the local operating company as working with the local bank with which they used to deal.

David Swann said: "It is important that the local company does not see degradation in service and pricing and we do provide additional services beyond a traditional bank. For instance we're flexible in how the local company communicates with us – it can be via email rather than by phone – and the discussion with the TSC can be about the underlying business which causes the exposure in the first place. The important issue to remember is that unlike the banks we are not here to make a profit. We are still a cost centre." A well set up IHB or TSC will ensure that the local operating company ensures that it is dealing with another part of the group not a third-party counterparty.

The BAT TSC provides two levels of service. The first level of service is the same as that provided by a bank. So the local operating company calls the dealing room and will talk about the particular transactions required such as buying some FX or placing some cash. In that mode the TSC is reactive. But

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increasingly the TSC is moving to a second level of service. This entails the TSC moving towards a more sophisticated model called the agency model. David Swann said: "In this model a lot of the activity at the end market is outsourced to the TSC."

**INTERNAL OUTSOURCING** David Swann paints the picture of what was happening at BAT 10 years ago with an FX exposure. The end-market would have cash forecasts and forecast of its FX exposure. It would apply the treasury policy on FX exposure which is laid out from the centre but was then interpreted locally. The local finance team would look at the exposure and the policy and would decide that they need to do some FX hedging. The team would work out what it wanted to do and then go and do it. The transaction would be completed with a local external counterpart. Fast forward 10 years: now under the TSC's basic service, the operating company would pick up the phone and do the deal with the TSC who, if they can, net it off against other, internal exposures, and then complete the deal.

Under the agency model the dedicated treasury professionals in the TSC take on the role of the local treasury people, receiving the cash forecasts and hedging within the policy set by the local management. And that is what is starting to happen with the TSC building up a portfolio of relationships where, in effect, a local finance director can outsource his treasury function to a single service centre. David Swann said: "This is a service some banks do offer as well but we think it works better in-house."

The model that David Swann has built up he describes as "not rocket science" (see the diagram). Along one axis you can represent the extent to which the transaction execution is either centralised or de-centralised. Along the other axis you can represent the extent to which decision making is either centralised or de-centralised,

The financial benefits moving along the transactional axis of who does the transaction and where are modest. There are savings in terms of spread and headcount but for BAT these were important but not substantial. The decision making axis, for example where hedging decisions are made is, for David Swann, the more interesting one.

He said: "This is the area that corporates need to think about carefully. In a decentralised organisation the approach to managing risk varies across the world depending on local conditions and risk appetites which can introduce inconsistencies and inefficiency. What we have been doing is bringing greater consistency to treasury management and the TSC is a powerful tool in achieving this".

You get an idea of the work that the TSC can cope with when you consider the dividend that BAT pays out. The final dividend of 42.0p per share that had to be paid out in one day in early May 2007 amounted to £821 million. The liquidity management including the planning and the management cash collection from the operating companies in order to meet this payment is all handled by the TSC.

While corporates may be able to move up along the transaction axis relatively easily, they are likely to find that it is more difficult to smoothly centralise the decision making.



## cash management

### TREASURY SERVICE CENTRE

David Swann explains why: "End markets who have been autonomous in the past and often they will see great benefits in that autonomy. What you have to do is balance that benefit with the advantages of looking on a global basis in terms of scale, leverage, netting off exposures and the consistency of hedging." David Swann is keen to emphasise that this is not about a simple centralisation but rather the treasury function sets out standards and policies. He says BAT now has consistency and coherence in terms of transaction execution and decision making where there are now clear group policies. He said: "The business we are in is relatively straightforward. You would expect a level of consistency from one operating company to the next in the way that it runs many aspects of its business and that would include issues such as FX hedging. Why should one company [in the group] decide to hedge 100% of its exposures while another may not hedge at all? You need to question why there are such fundamental differences."

The end result of the TSC implementation undertaken by BAT is that in Europe now over 90% of all the transactions go through the TSC. Where they don't it is usually because they can't, typically due to legal/regulatory/cross-border obstacles or because of size it may be cheaper to do the transaction outwith the TSC. As David Swann notes it is important not to be too dogmatic.

**A SHIFTING RELATIONSHIP** Implementing a TSC/IHB is bound to have an impact on the relationship the treasurer has with the company's banks. According to the BAT experience core banks benefit from a TSC at the expense of local banks. BAT has been focusing more business on the core relationship banking group. These banks are primarily defined

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by their provision of credit to the company in terms of committed borrowing facilities. The TSC allows the treasury department to aggregate a lot of the transactional business around the group, feed it through the TSC and target it on BAT's core relationship banking group. This creates a balance between the credit lines and the ancillary business which is valuable to the banks involved. BAT studies the data and is well aware of the value of the business to the banks.

David Swann said: "The TSC's dealing business is aggregated and competed for by our core global banking group rather than the numerous banks across the group with purely local relationships."

One of the key benefits of the IHB/TSC model is the emphasis which naturally falls on control. David Swann said: "We are aggregating the external treasury activity into one or two locations which enables us to really focus the effort on controls. The TSCs have become the flagships of treasury controls across the group. Naturally, we set very high standards because of the sheer volume going through; we have full-time dealers and full-time people dedicated to monitoring controls. It's worth implementing a TSC structure for this reason alone."

At the moment David Swann has two key objectives for the TSC. The first is to upgrade the systems. The system requirement is related to the idea of a virtual global TSC where the same systems are in use wherever the physical presence of the TSC happens to be. Once the systems and data are one then a global treasury becomes a reality with people working in different places, different time zones using the same IT and the same information. The second objective is to push the idea of the agency model to create the TSC as a provider of services to the rest of the organisation. That's where the real value lies.

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Figure 1: Possible ways ahead for an in-house TSC

