Harnessing the in-house power

JAMES LOCKYER LOOKS AT THE MOTIVATION FOR SETTING UP AN IN-HOUSE BANK.

Executive summary

This article asks what is an in-house bank? The two key features of an IHB are that an IHB enables a split to be made between operating unit transactional banking and group-wide transactional banking and all the rules of the IHB are set out by the entity. The classic reason for an IHB is to cut transactions costs, other advantages include allocation of funding, visibility, improving cash performance and greater organisational flexibility.

An in-house bank (IHB) is, simply, just what it says on the tin. It may be an entity in its own right, or it may be part of one; but it's a bank maintained by a company or group for its own internal purposes. The two key characteristics of an IHB are:

- The IHB provides an efficient means for participants to settle among themselves thus enabling the group to concentrate external banking activity and allow the IHB to act as a buffer between operating units and the external "live" bank, and
- All the rules of the IHB (such as interest rates, bank charges, value dating, cut-offs, procedures) are set by the company or group maintaining it.

An operating unit's net debt position is then:

	Balance on external bank accounts
+/-	Amounts borrowed or lent externally
+/-	Amounts borrowed or lent internally
+/-	Balance on IHB accounts.

Point one above means that "real" payments can be made centrally – by another operating unit or by a Shared Service Centre (SSC), say. Then the SSC simply funds the payment internally by charging the relevant operating units through the IHB. The SSC's overall position is net Nil; and operating units have paid via the IHB.

Point two is where the IHB can really score. External payments and receipts are limited by the conventions of the international cash management system. But the IHB can run entirely at the convenience of the user. Having made the payments or collected the receipts the SSC can charge or credit the operating unit at any stage most appropriate for

the group's management reporting cycle.This might be immediately or as part of the period end accounting routine.This is possible because unlike the real banking system, the IHB can value date transactions.

CLASSIC MOTIVATION The classic motivation for establishing an in-house bank is to cut transactional banking costs. Bank transactions can be aggregated into one centre, where netting techniques are used to generate the most efficient number of transactions both internally (i.e. over in-house bank accounts) and externally over "real" bank accounts. This type of activity can be set up as an extension of existing SSC-type activity, thus levering on existing economies of scale.

Other motivations revolve around providing increased visibility of operating unit cash generation, creating a better connection between operating units and centrally-provided finance, fairer evaluation and incentivisation of performance, and hence improved overall control. This potential real-time insight into all inter-company relationships and total bank balances (i.e external and IHB), gives central treasury added visibility. The treasurer can include in-house bank balances to arrive at the total funding position for the subsidiary enabling

it to set and follow-up cash generation or borrowing targets. There are a number of other uses for IHBs, though all using the ability of the IHB to provide a disconnection between operating unit cash flows and real bank accounts.

ALLOCATION OF FUNDING The IHB can be used to allocate funds sourced externally, and direct them precisely to operating units. Without an IHB, operating units can be funded by intercompany loans, but then they have either to hold cash or borrow locally to meet their day to day needs. With an IHB, both loans and day-to-day funding/defunding can be provided via the IHB, leading to more efficient utilisation of group cash (or borrowings), in a way that is visible to all participants.

IDENTIFICATION OF TRUE CASH GENERATION Cash pooling and concentration structures often cloud operating units' true cash generation or absorption. The IHB can be used to compensate for cash concentration movements, thus preserving all parties' visibility of operating units' true cash generation.

INCENTIVISATION FOR CASH PERFORMANCE Since an IHB can accrue interest on a daily basis on actual balances outstanding, funding costs can be allocated accurately on a daily basis to operating units rather than merely at period ends. As a result they see the true effect of their cash performance, rather than one based on period ends and accounting cash.

HEDGING ACTIVITY An IHB allows operating units to be delegated with decision making for hedging. As long as operating units deal with the IHB, then within policy limits the IHB can choose to back the transaction directly in the market, amalgamate it with others, or do nothing at all. Conversely, the IHB can hedge the group position if need be independently from operating unit management's decision. This allows operating units controlled autonomy; it also allows visibility of whose strategy turned out better, via an analysis of FX gains and losses in the IHB.

ORGANISATIONAL FLEXIBILITY Once an IHB is established, individual operating units may well not require real bank accounts – they bank with the IHB instead. This gives the group the flexibility to set up new ventures on a test basis – perhaps with very low volumes; and to monitor their cash performance without having to go through time consuming real bank account opening procedures. Similarly the IHB gives the flexibility to deal with "on behalf of" payments and receipts, and allocate them efficiently and visibly to the correct operating unit, with full interest compensation. The IHB provides a clear, visible and fair means of charging interest; consistent with transfer pricing rules, but on a basis that can be moulded to suit the group.

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A primary source

Before a company can consider an IHB it needs to satisfy certain conditions:

- Are the numbers big enough to make the investment worthwhile?
- Is there a sufficient level of expertise in-house to run such a function?
- Does the company have a high enough credit rating that it can hedge its positions economically?

REDUCING GROUP BANKING COSTS The main reason for using an in-house bank is to reduce group banking costs through:

- Reducing the number of banks and bank accounts overall.
- Minimising the number of transactions done through the banks (intercompany payments will be cashless transactions passed over the accounts of the IHB).
- Offsetting group-wide currency positions.
- Maximising the size of transactions for borrowing, investing and foreign exchange.

The IHB effectively centralises all banking activity with internal specialist treasury staff operating from one centre of excellence (either regionally or globally) more efficiently and for less cost than at individual company level.

The drawbacks are the same as for any centralised treasury:

- An IHB may not understand local nuances.
- Internal pricing must be monitored very closely to make sure it is in compliance with arm's length requirements.
- Operational risk is concentrated and so systems and controls need to be enhanced.

IN-HOUSE BANK FUNCTIONS The main functions typically performed by an IHB are:

- **Long-term investment and funding** Most large corporations that need to borrow or invest funds find it beneficial to establish a long-term strategy based on the aggregate shortages or surpluses across the group with a view to borrowing or investing at the group level rather than

at an individual company level. For example, on an aggregate level, the IHB may have access to cheaper funding such as commercial paper.

- **Foreign exchange and exposure management** The IHB allows a company to aggregate and net out the group's foreign currency trading requirements and manage the risks so that fewer and larger deals can be carried out by the group with its banks. Negotiations by IHB staff can reduce FX spreads by as much as 0.25%. Highly centralised groups insist that all FX transactions are carried out through the IHB. Using netting, in-house factoring or reinvoicing techniques can further reduce the need for subsidiaries to do FX deals.
- **Cash and liquidity management** By undertaking cash management for the group the IHB becomes responsible for:
  - Bank selection.
  - Short-term and overnight investment.
  - Short-term lending.
  - Short-term currency swaps.
  - Interest apportionment.
  - Statement rendering.

Large companies can obtain better transactional banking terms by concentrating all their banking activity through one bank in each country. (It is rarely possible to concentrate all banking activity for one region through a single bank). This enables substantial economies of scale, including negotiation of reduced per item charges, credit interest on operational bank accounts, and interest offset pooling or balance concentration.

Managing country cash pools (or concentration systems) from a central location enables the IHB to provide cross-currency funding by "swapping" surplus currencies for those currencies which have deficit pools (thus further extending the concept of intercompany funding for short-term positions). While such techniques are usually applied to "core" deficits and surpluses (often monthly or biweekly based on cash forecasts), some companies are now doing this on an overnight basis. Using swaps means that only residual or unplanned positions are left in current accounts; and even these can attract a reasonable rate of return if these are interest-bearing and/or linked to auto-investment services. Finally, the IHB needs to be able to issue "bank statements" for each subsidiary showing transaction details and interest apportionment.

- **Central management of bank relationships** IHBs normally take group responsibility for setting up and managing all group-banking facilities for credit, transactional banking and trading purposes. This invariably leads to:
  - A substantial reduction in the number of banks used.
  - A concentration of business with banks that are particularly noted for their expertise in certain areas of business (e.g. trade services, cash management, exotic currencies).

This generally results in strengthened banking relationships and better pricing.

IN-HOUSE BANK SYSTEMS By their very nature, IHBs have to be staffed by high calibre individuals supported by automated systems. The very basic system requirements include:

- Multi-bank electronic balance and transaction reporting and upload capability.
- Cash forecasting system.
- Electronic funds transfer capabilities.
- Electronic rates service (Reuters, Bloomberg etc.).
- Treasury management system.
- A bank-type accounting system.

For a central treasury or in-house bank to be able to manage cash on a day-to-day basis, it must be able to monitor the group's bank accounts each day. Most leading banks' electronic banking systems now enable other banks to report into them, either using the SWIFT network or third party data exchange systems, thus enabling "multi-banked" companies to use just one bank's electronic banking system to monitor all their accounts. Some banks can also offer companies the ability to initiate electronic funds transfer (EFT) instructions on a multi-bank basis using the MT101. EFT is, of course, necessary to move surpluses between accounts at different banks, often in different currencies, as well as to settle transactions that require "real" bank accounts.

IHBs need a comprehensive treasury management system that will not only enable consolidated position reporting and management by currency or country, but also facilitate management and reporting at the subsidiary level. Such systems must have strong multi-currency capabilities and provide management and exception reporting as well as planning and forecasting functions. Depending on the system it may also be able to undertake the statement rendering function. Some large corporations build their own systems, but many choose to buy one of the many treasury management packages that are now generally available.

IMPACT OF IN-HOUSE BANKS ON THE BANKING INDUSTRY It is clear that the growth of in-house banks is one more step towards corporate disintermediation of banks. As more companies are moving towards centralised treasury operations, the in-house bank concept is likely to become a natural progression, offering as it does so many opportunities to reduce external transaction volumes, the numbers of banks used and banking costs. Technology facilitates the move to centralisation, while regulatory requirements add a strong incentive.

While some banks will inevitably lose local business, others will end up with very significant relationships, often on a regional or global basis. Such banks are attracting multinational customers through a combination of price, service quality, network coverage and integrated systems. Interestingly enough, these are not just the "global banks" but also many smaller regional banks that really understand their customers and develop innovative solutions to satisfy their requirements.

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