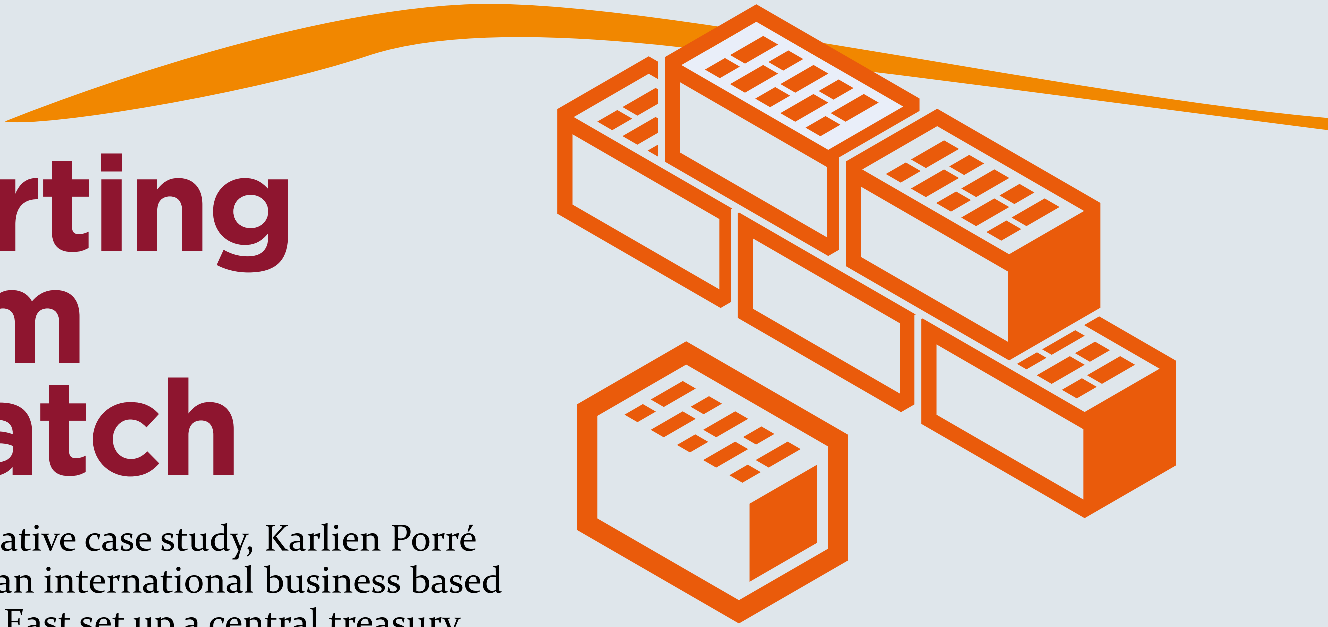

Starting from scratch

In this informative case study, Karlien Porré explains how an international business based in the Middle East set up a central treasury function for the first time

The regional treasury community in the Middle East is buzzing with many interesting developments, which is a reflection of the growing role of treasury professionals in the Middle East and companies in the region increasingly aiming to adopt best treasury practices. Numerous companies are planning (or have started to plan) the establishment of a central treasury function, and those that already have one are exploring ways to automate and streamline their operations, through improved or centralised cash management and appropriate IT infrastructure.

During the past year, we have been supporting an international business in setting up a central treasury function, including cash-pooling arrangements and treasury policies. This article draws attention to some of the considerations and challenges associated with the local market and practices.

Background

The company is a $3bn regional market leader in retail and distribution, and has operations in most of the Gulf Cooperation Council countries, including Kuwait, Qatar, Saudi Arabia and the United Arab Emirates (UAE). Its recent growth had resulted in the need to formalise treasury policies and procedures, and seek efficiencies in the way cash, debt and FX exposures were managed. The latter was to be achieved through centralisation and implementing the supporting infrastructure – this included recruiting qualified treasury staff, selecting a treasury management system (TMS) and choosing an international cash management banking partner.

In relation to the cash management work stream, the main objectives were typical of many treasury cash management projects: to gain central visibility of all bank account balances, and to automate the centralisation of balances to minimise interest and facilitate easy investment of surplus cash at the centre. While these objectives are simple enough, the structure of the company, the diverse nature of existing banking relationships and the maturity of the market meant that some creative solutions had to be explored.

Planning and selection

The first stage of the project focused on determining the requirements and structuring potential solutions. This was critical, since the subsidiaries in the scope of the project operated a total of 190 bank accounts, typically spread over 19 different banks and covering 12 currencies. This phase included meetings with banks to understand their product offerings; meetings with business units to assess their current operations; and assessment of various regulatory restrictions in some of the countries concerned.

It culminated in a business case that set out the merits of potential structures, and an agreed list of potential banking partners. In addition to the benefits from improved FX management and process automation, savings from liquidity management arising from increased visibility of cash balances and cash concentration were estimated at between $230,000 and $455,000 per annum – arising mainly from saved overdraft interest and increased interest earnings.

The banks' responses to the request for proposal and subsequent presentations brought to light a number of the challenges:

- Bank regulation does not allow debit and credit balances to be set off for capital calculation purposes, and hence notional pooling solutions are more expensive for banks to offer. This means that you are more likely to get a notional pooling only as part of wider banking relationship and it pays to work with existing banks. (Note that, with the new Basel III liquidity ratios coming up, this is also likely to change the notional pooling environment in the rest of the world, unfortunately, to the cost of the corporate.)

LESSONS LEARNED

- Educating the business and management about mutual benefits (for the group and for the individual business units) is critical to the success of moving to centralised cash management.
- Set realistic expectations about the solution and understand the banks' capabilities.
- Executing the legal documentation can take longer than anticipated. Make time to plan upfront and involve the legal team from the start.
- Allow dedicated resource with responsibility for project management and coordinating different workstreams such as the banking and TMS solutions.

- Regulatory restrictions in some countries around cash pooling and intercompany transactions need to be managed. Saudi Arabia imposes most of the restrictions, with notional pooling not allowed; cross-border cash pooling requiring work-around solutions or manual interventions; restrictions on intercompany balances; and withholding tax considerations.
- Banks in the region are, in many cases, still developing solutions. Combined with the regulatory restrictions, this means that some products – such as notional pools in some of the countries or cross-currency pools – are either unavailable or uneconomical.
- Many companies in the region have complex shareholding structures, often involving minority shareholders in order to comply with local company laws. This can complicate the legal status of the cross-guarantees for non-wholly owned subsidiaries that are needed for notional pooling arrangements. Hence, physical pooling structures may be required instead. It also means that intercompany pricing is important, not for the usual tax reasons, but to ensure minority shareholders perceive the interest rates on the pooled accounts as good value and are thus willing to sign up to the structure.
- The company had a decentralised approach to funding, which is not uncommon in the region, with credit facilities held at the operating company level. This required careful planning to ensure that the credit facilities required at the pool header level could be raised.

The scoresheet-based assessment of the banks' written responses and presentations led to the chosen solution, provided by one of the company's three main relationship banks and consisting of three single-currency notional pools in the UAE, feeding into a cross-border interest-rate optimisation structure. Surplus balances in foreign entities are swept to its accounts held with the cash management bank, in country, and thus participate in the cash concentration and interest-enhancement structure.

It was decided, at this point in time, not to centralise all accounts to one bank, primarily for operational reasons, and to support the provision of credit facilities. This meant that the international overlay solution had to be connected to other local mini-pools that were set up with two to three other UAE banks that held material balances, as well as local banks in the foreign territories.

With respect to the bank connectivity requirements, direct Swift connectivity via Alliance Lite2 seemed appealing, both in terms of capabilities, but also price, given the many banking relationships. But as the treasury team was very young and had a heavy workload with setting up the full treasury function, including the TMS – as well as the need to educate the operational finance teams on the mechanics and benefits of centralised treasury management – it was decided to outsource the bank connectivity solution to a shared service bureau (provided by the same provider, and in an integrated manner, as the selected TMS solution).

The process up to selection took around five months, to an extent reflecting some interruption during the Ramadan period, when things progress generally at a somewhat slower speed.

Implementation

The key next step was to execute all necessary documentation. This, perhaps not unsurprisingly, was a very onerous process. Cross-border, multi-entity pooling structures always require numerous documents and resolutions, but a number of factors made it more complex in this instance. As an example, one bank with a European parent had two sets of requirements, one from the local entity and another from its parent company in Europe. Complex ownership structures further complicated the implementation process, since the minority shareholders of all subsidiaries needed to execute necessary board resolutions and documents, giving rise to potential delays.

This definitely brought home the value of reviewing (and planning for execution) samples of all documentation that are required for the solution. Another critical element was to involve the legal team very early on in the project and make the legal team a stakeholder in the project from the start to get their input and keep them on board.

Testing and operation

Once all board resolutions and documents were signed, the actual process for the banks setting up the cash pools was straightforward. Clear communication between the company and banks had ensured that details of the participating accounts were well understood. The set-up was followed with the usual testing and this highlighted some mistakes that were quickly rectified by the bank.

The infrastructure is now set up and the company's new treasury team is currently embedding the processes. A post-implementation review will be carried out to confirm that the business case benefits have been achieved.

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