The case for centralisation

CASH POOLING HAS BEEN A MAJOR DRIVER IN THE MOVEMENT TOWARDS CENTRALISATION BY CORPORATE TREASURIES BUT REGULATION SUCH AS SARBANES-OXLEY IS ALSO HAVING ITS IMPACT. BY **GARY STARLING**.

The degree to which corporate treasuries are centralised can cover a wide spectrum but, generally, they can be classified into three main types:

- global treasury;
- regional treasury;
- local treasury (effectively decentralised).

Global treasuries are common among multinational companies with a worldwide presence and there has been a growing movement towards this type of structure among organisations that have grown and diversified. The advent of regional treasury centres, payment factories and Shared Service Centres (SSCs) have also facilitated a move towards this type of structure.

Regional treasury centres are the most common and this is the structure that many treasuries are currently moving towards. This is particularly the case in Europe, where the advent of the euro and the increasing size of the European Union have made this a market reality.

Decentralised treasuries do exist but they tend to be either in organisations that have a strong philosophy of autonomy or those with less diversified international operations.

However, it is not always easy to classify treasury departments into specific categories as some treasury functional areas may be managed differently. For instance, debt management tends to be centrally organised, while commodity risk is often managed locally. The 2004 Ernst & Young Treasury Operations Survey, conducted in association with the ACT (see Delicate Operations, page 13, *The Treasurer*, October 2004), found 46% of respondents managed debt at a local level.

MORE FOCUSED TREASURY. The Ernst & Young survey also revealed a trend towards more focused treasuries, and this has meant centralisation for many organisations over the last decade. A number of factors have accelerated and facilitated this process, but centralisation itself is not necessarily a planned process and often happens in a piecemeal fashion as the result of changes in management philosophy or technological advances.

The survey revealed that the core responsibilities of treasury departments are cash management, risk management and handling bank relationships (see *Figure 2*). All these functions are generally inter-linked and, given the level of globalisation in the banking market and in the corporate sector, this has encouraged the move towards centralised treasury further still.

In the last few years many decentralised treasuries have started implementing in-country and European cash pooling. This has led to the creation of central treasury departments which manage the cashpool at

Executive summary

- There are three main types of treasury structure but regional treasury centres are predominant.
- The trend is towards further centralisation – moving from localised treasury operations to a regional structure. The major driver for this has been cash pooling and the movement has been facilitated by technology.
- Other key factors that have influenced the current trend towards centralisation are new regulations such as the International Accounting Standards and Sarbanes-Oxley.
- The benefits of centralisation are cost savings, improved management control, exposure netting, economies of scale and staff specialisation.
- The process of centralisation should involve a project management approach and ensure that senior management buy-in has been secured before the project's commencement.

the centre. Technological advances in the form of Electronic Banking Systems (EBS) and Treasury Management Systems (TMS) have increased the take-up of cash pooling.

Establishing a cashpool can often result in management taking a fresh look at their banking relationships and rationalising them where possible. Local bank relationships are often pruned. Group treasury can then concentrate on building stronger relationships with the remaining core banks.

A second major factor is risk management. Foreign exchange management used to be a key driver for having a central treasury head office. However, transactional exposures have reduced for some companies, mainly due to the advent of the euro and the enlargement of the European Union. There is also increasing reliance on natural hedging techniques.

A third factor behind the movement towards centralisation is regulation. The International Financial Reporting Standards (IFRS) and, in particular IAS 39, are major challenges to many corporate treasurers, and many companies want to avoid earnings volatility and hence will elect for hedge accounting wherever possible.

This brings with it an administrative burden of documentation in the form of hedge effectiveness assessment and testing. Although companies' operating units tend to own the underlying exposure, this information must be accessible at group level. This is needed to ensure that the correct documentation can be put in place and the hedge effectiveness assessment carried out. This is often considered a specialist area that needs to be managed and controlled at the centre.

Regulation such as Section 404 of the Sarbanes-Oxley Act (see No shelter from the storm, page 16, *The Treasurer*, October 2004) will also force more companies to document their processes and assess their risks and controls. This can be achieved more efficiently and effectively with central direction and a standardised approach.

Finally, technological advances such as web-based EBS and TMS and online foreign exchange platforms have facilitated the move towards central treasuries that require dedicated specialist staff.

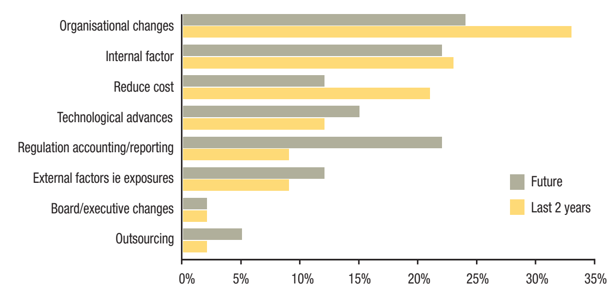
WHERE DOES CENTRALISATION WORK? Centralised treasuries used to be the premise of large multinationals or companies where there was significant intra-group trading, such as companies operating in the manufacturing sector. This is no longer the case with centralisation being important for less diverse and smaller organisations too.

The focus often begins with one functional area such as cash or debt management. As smaller organisations move away from overdraft financing to bank debt or even to the capital markets, there is recognition that this requires a dedicated specialist team at the centre.

Centralisation is vital for companies that have a lot of overseas subsidiaries and where there is intra-group trading. Netting systems have been used for some time to reduce foreign exchange risks, and can help to formalise inter-company settlement.

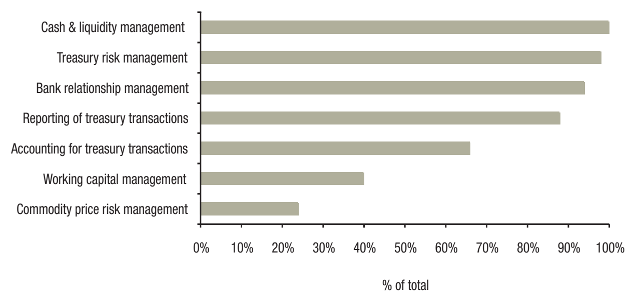
Some treasury functions may need to remain decentralised with expertise residing at the operating unit. If the organisation has a

Figure 1
Factors affecting the size of the treasury department



In the recent Ernst & Young survey, over 40% of respondents said they are expecting their department sizes to remain unchanged. This means that over half of them are anticipating changes as a result of organisational modifications, regulation, accounting/reporting and other factors. The most common size of central department was four to eight people, but there was limited growth.

Figure 2
Treasury responsibilities



Why centralise?

Centralisation can generate many benefits:

- **Improved control, that is visibility of cash within a group;**
- **Concentration of the specialist staff needed for commodity hedging and debt financing;**
- **Cost reductions in the form of a reduced treasury staff headcount across the group;**
- **Better pricing for bank services such as facilities, cash pooling and daily transactional costs;**
- **Netting of exposures that may have been individually hedged;**
- **Easier compliance with regulation such as documentation for International Financial Reporting Standards (IFRS) and Sarbanes-Oxley.**

There are, however, drawbacks that may occur as a result of centralisation:

- **Negative impact on staff morale due to job losses or job content changes;**
- **Loss of autonomy within the local units;**
- **Increased head office costs and the political implications of centralised control.**

The benefits to be accrued from a centralised treasury		
Functions	**Benefits of centralisation**	**Benefits of local treasury**
Cash management	■ Cash offset for operating companies using cash pooling techniques for improved group liquidity; ■ Improved visibility of cash positions; ■ Lower interest cost and/or higher interest income.	■ Local team is closer to cashflows and hence greater accuracy of cash forecasting.
Funding	■ Negotiation of facilities improved due to economies of scale and central expertise; ■ Development of stronger relationships with a focused core group of banks; ■ Standardised debt terms important for covenant compliance.	■ Local bank relationship expertise is often essential in some regions such as Asia.
Foreign exchange management	■ Opportunity to net transactional exposures (the use of a multi-currency netting system is a major benefit); ■ Improved exposure monitoring; ■ Better pricing for hedging costs due to economies of scale and dealing expertise; ■ Need for consolidated information on cashflows around the group for management of translational exposures.	■ Local team is able to react faster to transactional exposure changes or on contract-based transactions.
Other risks – commodity & credit risk	■ Commodity hedging is often a specialist area requiring specific market knowledge; ■ By pooling exposures the increased transaction size makes the hedging more economic; ■ Credit risk is normally measured and controlled centrally as this requires consolidated information across the group.	■ Local market knowledge of commodity requirements. The contractual arrangements can be vital.
Governance	■ Treasury policy is predominately set at the centre. A consistent approach improves the group's awareness of the exposures and how they should be managed; ■ Recent changes in regulation have meant there is a move towards standardised procedures and documentation; ■ The improved control and reporting gained through the use of available technology has also led to cost savings.	

franchise-type structure, centralisation may have a negative impact on the organisation. Similarly, companies that have limited overseas operations may feel that a centralised head office would only be a burden and an additional cost to the group.

HOW TO CENTRALISE? Centralisation can take many forms and is often attempted by business processes rather than being seen as an end in itself. For a company that has expanded rapidly by acquisition, a formal plan to centralise most treasury functions is required.

It is often the case that some functions are already group-controlled such as debt management and treasury policy. This means it is just a matter of adding cash management or foreign exchange to the portfolio of functions already administered by the central treasury. The key factor is the group's strategic vision and where group treasury fits into this framework. The treasurer needs to gain buy-in from the CFO or the board if he wants to implement wide-ranging changes.

Before implementing a centralisation plan, a cost/benefit analysis should be carried out. If the benefits of centralisation can be quantified, this strengthens the argument for change. However, qualitative factors such as improved control and better reporting can be equally important considerations. Centralisation is similar to any other investment decision and should be treated as such.

One of the best ways in which a treasurer can convince the board of his proposed actions is by presenting a persuasive paper. It may also be beneficial to obtain independent advice to prepare the paper as the treasurer may not be seen as impartial. Centralisation may be resisted by a treasurer's counterparts in the operating divisions who do not want to relinquish control of their bank relationships and are concerned about the impact this may have on their staff.

A centralisation project should be broken into key activities, that is: defining the objective, breaking the objective into various tasks, establishing a timeline and making sure the project has a suitable sponsor. It is important to have a clear plan and attempt to complete the project in a reasonably tight timeframe. A relatively efficient implementation will help minimise organisational disruption and maintain focus on the project.

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