5.3.1 Special Purpose Treasury Structures

Unit: Unit 1 – Treasury Strategy

Module: Module 5 – Treasury structure

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Summary: A review of the different types of special treasury structure, including payment and collection factories, shared service centres and in house banks, netting and re-invoicing centres.

Keywords: payment factory, collection factory, shared service centre, in-house bank, multicurrency netting centre, re-invoicing centre, export finance centre, financial intermediary, service level agreement, enterprise-wide resource planning system

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Learning outcomes:

1. Payment factories allow international payments to be re-packaged as local payments, savings costs, among other benefits.
2. Collection factories can offer similar benefits as payment factories although they may be more difficult to achieve.
3. Shared Service Centres can perform many business activities in an economic way, including cash management but not usually strategic treasury.
4. In House banks are in many ways the ideal treasury structure, giving control over activities as well as economies and centralisation of expertise and things such as banking relationships (as far as is possible).
5. Systems are very important to In House Banks
6. Multi currency netting centres have been an unsung hero of treasury for many years, saving on cross border transfers and foreign exchange spread.
7. Re-invoicing centres can give efficiencies but can only deal with invoiced exposures (transaction).
8. Export finance centres allow expertise related to export finance and export credit agencies to be used effectively and use limited resources of credit risk appetite to good effect.
9. Financial intermediaries are commonly used for minimisation of tax.
10. There are disadvantages to some of these structures.
11. The fallout from the financial crisis has caused some of these structures to be less appropriate as the banking world tends away from globalisation.

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1 Introduction

In many businesses, the operational structure does not coincide with the legal ownership structure, and this may be for logistical, tax or legal reasons to name but a few. At the treasury level the same argument applies – for instance treasury may be located (legally) within a principal trading company, in a headquarters company, in the ultimate holding company, or in a special purpose entity. The factors driving treasury's location in the business are the same as those driving the location of commercial activities, such as proximity to suppliers and customers, 'friendly' legal and tax treatments, ease of doing business and availability of personnel.

In the reading we cover the following special purpose structures:

- payment factories
- collection factories
- shared service centres
- in house banks
- multi currency netting centres
- re-invoicing centres
- export finance centres
- financial intermediaries

You should bear in mind that these structures, just like commercial structures, can be run as departments within a legal entity, or as legal entities in their own right.

2 Payment factories

A payment factory can be set up to handle the group's payment orders although the accounts payable function often continues to be handled at the local level. A payment factory is a centralised facility that undertakes the execution, administrative and reporting functions associated with payments. Ideally it gathers the payment instructions for the group into one file and sends them to the bank through a single electronic payment gateway. The payment factory usually covers central bank reporting and management of intercompany transactions. It receives all account and transaction information from the bank(s) and then distributes it to the relevant subsidiaries for reconciliation purposes, usually electronically by e-mail or web browser.

Payment factories can deliver important benefits:

- Significant cost savings can be generated by reducing both the number of banks used and the overall cost of payment transactions.
- Expensive cross-border transactions can be re-formatted and re-routed as cheaper domestic payments.
- Central bank reporting is handled on behalf of subsidiaries.

- Subsidiaries need not maintain external bank accounts for payments or electronic banking packages.
- Reconciliation is centralised.
- Having a single gateway allows for standardised interfaces and greater efficiency.
- Use of payment factories also enhances control, security and risk management.

A payment factory will, however, require a common technology platform such as an ERP system within the group, and efficient communications both internally and between the payment factory and the bank(s). It may also be necessary for the local subsidiaries to retain a local bank in order to handle confidential payments, such as payroll, and time critical ones such as tax payments. Physical cash requirements also need to be managed somehow and these usually require a local bank.

3 Collection factories

Once companies have established payment factories, they often extend the concept to the accounts receivable function with a collection factory. Depending on the nature of the accounts receivable, and the location of the receipts bank accounts, this may or may not create the same efficiencies as a payment factory.

Limitations include:

- Small value, high volume payments are normally not handled well cross-border, so a collection factory may need to maintain per country bank accounts and then remit on to a central location.
- There may also be issues for customers paying into accounts owned by the collection factory rather by than the person invoicing the customer (this can be dealt with by using a re-invoicing centre - see below).

4 Shared service centres

A shared service centre (SSC), acts as a single business unit in which common finance and administrative functions are performed for multiple subsidiaries. An SSC delivers services to other subsidiaries or business units, regulated by service level agreements (SLAs).

Companies have used long used SSCs to perform task such as:

- human resources
- facilities management
- procurement
- internal audit
- marketing
- advertising and public relations
- product distribution
- tax and legal compliance

- travel arrangements
- expense processing
- information technology
- finance (particularly fixed assets, accounts payable, accounts receivable and general ledger functions)

In the area of cash management some of the functions for which SSCs are being used are:

- bulk payments, especially international payments
- local in-country paper collections, using lockboxes
- e-commerce applications such as e-invoicing
- foreign exchange processing
- account reconciliation
- trade finance
- tax

There are a number of requirements, however, in order for an SSC to achieve maximum efficiency:

- a fully integrated accounting or ERP system for the group
- skilled staff
- centralised cash management
- a treasury management system

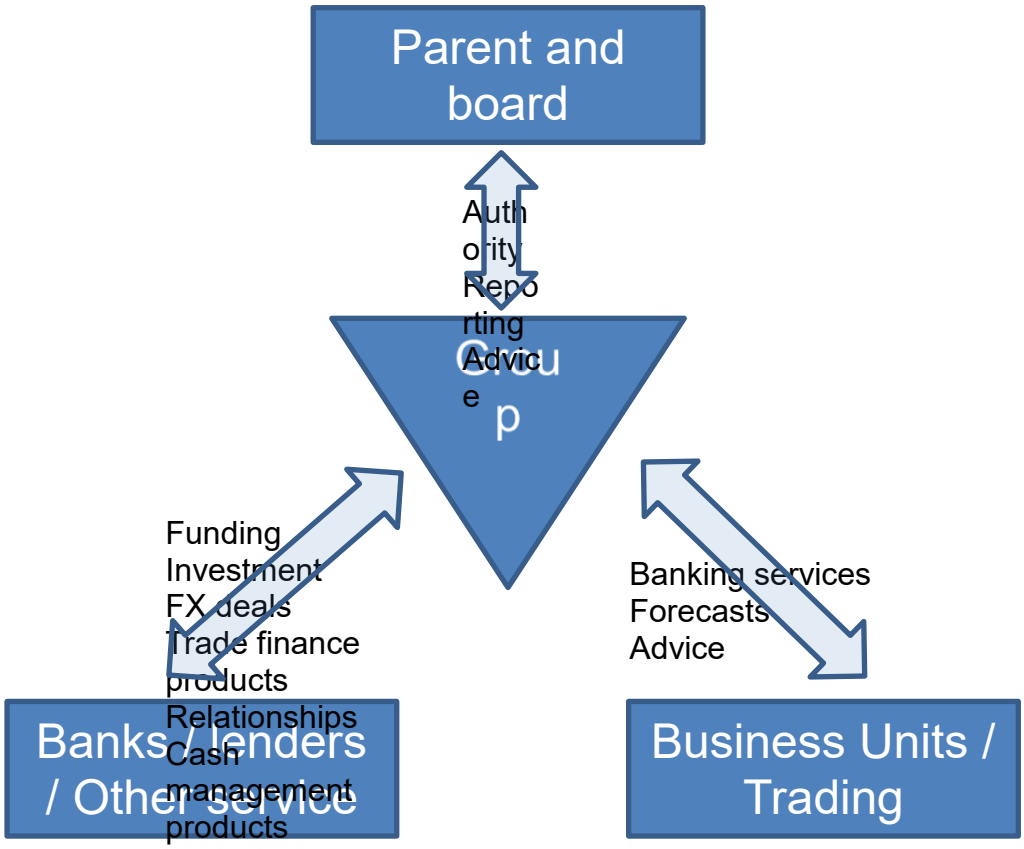
From a cash management perspective an SSC can lead to a significant reduction in costs; greater straight through processing, improved working capital position due to streamlined collections and improved forecasting due to centralisation of financial information. It also provides benefits to the subsidiaries by allowing companies to better focus on their core business. SSCs have become increasingly popular with multinational companies in North America, Europe and Asia.

In-house banks and payment factories are often the precursors of some of today's largest SSCs. Historically, larger groups have been at the forefront of the development of SSCs (largely due to the huge systems costs). Today banks and third party vendors are offering outsourcing services which make an SSC a viable option for smaller companies.

5 In-house banks

An in-house bank (IHB) is a vehicle where group treasury acts as the primary source of all banking services to operating units on an arm's length basis. It aggregates and nets out internal transactions; only the differences are placed with real banks. All banking transactions for the group are conducted through the IHB (in some companies, only cross-border transactions go through the IHB, while local transactions continue to be done with local banks). It can be either part of a global centralisation strategy or a totally decentralised structure.

Exhibit 1: In-house bank



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 central treasury have the systems to run the IHB, and to provide operating units with the visibility they need over balances and transactions?
- Does the central treasury company have a high enough credit rating (and hence sufficient facilities) to act as a single portal for the group? It will need facilities to handle the entire group's needs for borrowing, hedging, perhaps guarantees, cash management and settlement, and so on. Note however, that in most cases, the treasury company will enjoy a guarantee from the parent or another highly rated subsidiary.

5.1 In-house bank overview

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

In addition, an IHB can be used to perform important control functions. It can:

- measure operating units' cash generation performance and funding utilisation in real (as opposed to accounting) terms, and effectively in real time
- be used to allocate funding to operating units and to allocate them internal funding limits
- allow operating units to be managed in as much or as little detail as the group needs, thus enabling effort to be directed to the most important areas
- monitor exposures in the form of forecast cash flows
- validate forecasts and actual outturn by comparing to historic actuals
- separate internal transactions from external ones, allowing operating units the ability to hedge their own exposures with the IHB (while treasury hedges the group position with the market)
- Allow control to meet corporate governance requirements such as those in Sarbanes-Oxley.

The IHB effectively centralises all treasury 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 transfer pricing requirements
- operational risk is concentrated and so systems and controls need to be enhanced
- local motivation may be reduced

5.2 In-house bank functions

The main functions typically performed by an IHB are:

Long-term investment and funding: The IHB manages the entire group funding plan, funding and de-funding operating units as necessary based on their forecasts and actual performance. This would be automatic as far as possible.

Foreign exchange and exposure management: The IHB allows a company to forecast, 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. Netting, in-house factoring or re-invoicing techniques can further reduce the need for subsidiaries to do their own foreign exchange deals (see below).

Netting and foreign exchange matching: Multilateral netting is a process of offsetting payables owed by one subsidiary to all other subsidiaries against receivables due to it from all other subsidiaries. These systems can also include third party payables and receivables.

If the IHB acts as the netting centre it will handle all the calculations, currency purchases and sales, and exposure management, enabling participant companies to make or receive a single payment on settlement day in their home currency.

Additionally, some companies use the netting process to perform foreign exchange matching. Subsidiaries that need either to sell or buy currency can do this via the netting system, settling in their home currency, thus eliminating the need to hold foreign currency accounts, or to buy or sell currency through local banks.

Re-invoicing[1] and in-house factoring: Two other techniques that are used to centralise foreign exchange risk and to manage intercompany liquidity are re-invoicing and in-house factoring.

Re-invoicing is a process whereby all intercompany transactions are channelled through a re-invoicing centre. The re-invoicing centre undertakes the purchases on behalf of the subsidiaries, takes title to the goods and then invoices the ordering party. The subsidiaries invoice or make payments in their own currency, passing the foreign exchange risk onto the re-invoicing centre. The IHB can act as the re-invoicing centre managing the intercompany payments, running the netting, and also leading and lagging settlement, as appropriate.

With in-house factoring, similar to external factoring, the IHB manages group liquidity by buying receivables (usually on a recourse basis) from the subsidiary at a discount. The discount is usually at a lower interest rate than could be obtained from an external factor. Customers then pay directly to the IHB.

Settlement of factoring and re-invoicing transactions can usually be included in the netting cycle, enabling only one amount to be paid into or out of the IHB account for each subsidiary each netting cycle.

Cash and liquidity management: By undertaking cash management for the group the IHB becomes responsible for:

- bank relationships
- managing cash pools
- short-term borrowing & investment
- short-term currency swaps
- interest apportionment
- statement rendering

The IHB optimises transactional banking terms by concentrating all its external banking activity through one bank in each country. (It is rarely possible to concentrate all banking activity for one region through a single bank although SEPA may be able to achieve this in the European Union area). This enables substantial economies of scale.

Managing country cash pools (or concentration systems) from a central location enables the IHB to provide cross-currency funding by ‘swapping’ pool surpluses and deficits. While such techniques are usually applied to ‘core’ deficits and surpluses (often monthly or weekly based on cash forecasts), some companies are now doing this on an overnight basis.

[1] Here we are talking about intercompany re-invoicing.

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: Use of an IHB 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. innovative risk management products, trade services, cash management, exotic currencies).

This generally results in strengthened banking relationships and better pricing.

5.3 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:

- bank communication systems
    - multi-bank electronic balance and transaction reporting
    - electronic funds transfer capabilities
- cash forecasting / exposure gathering system
- 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 and instruct over the group's bank accounts each day. Most leading banks can offer this functionality although IHBs may need access to several different banks (e.g. to manage cash concentration arrangements in different countries). Some treasuries are moving to the use of SWIFT to deal with this proliferation of systems.

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. Note, however, that some functions, particularly cash flow forecasting, may already be handled by the group financial consolidation system and care must be taken to avoid duplication of function, system or communication methods, or else operating units may find "Head Office" very confusing.

6 Multi currency netting centres

Often part of an in-house bank, multicurrency netting centres can also exist on their own. A multicurrency netting centre is a subsidiary (or simply a set of treasury controlled bank accounts) used by large international companies to centralise and coordinate currency cash flows and balances among all of the other subsidiaries of the parent. In addition, the netting

centre may monitor and control the liquidity of the entire group, channelling funds where appropriate.

In many cases, the multicurrency centre is used to 'pool' all of the foreign exchange (FX) risks in the group by settling all FX payables and receivables. By centralisation, the centre should be able to match or net as much as possible in-house and to deal in the largest amounts possible with external financial institutions - thus improving rates obtainable and eliminating bid/offer spreads. By centralising dealing activity, specialised trading staff can be employed to improve overall expertise and competence in this area. These centres are often known as 'multi-lateral netting centres'.

As in most international treasury considerations, taxation plays a large part in determining the viability of any particular decision. Some of the largest firms locate multicurrency treasury operations centres in low tax jurisdictions which have tax treaties which reduce any withholding tax (Switzerland, Cayman Islands, Channel Islands, etc) which might arise on the payments. Multicurrency centres must be seen to earn some revenue from their activities in order to qualify for favourable taxation treatment.

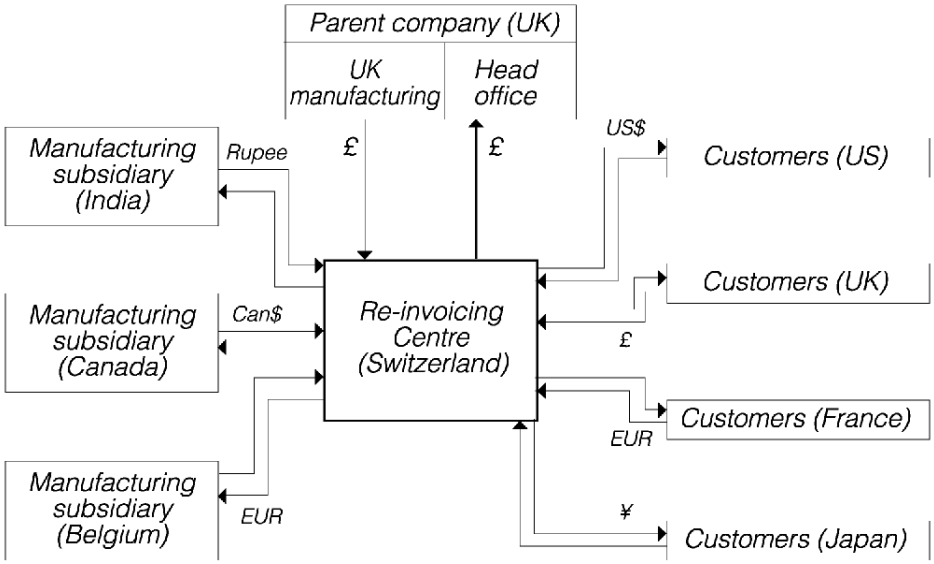
7 Re-invoicing centres

A re-invoicing centre is an international treasury function through which sales invoices (intercompany and external) are routed. The purposes of such a facility are to:

- centralise FX exposure to one centre (as for a multicurrency netting centre)
- by centralising invoicing, gain efficiencies in:
    - liquidity management from pushing more transactions through fewer bank accounts
    - invoice administration
- by re-invoicing ensuring that the 'collection factory' is the same entity as the invoicing entity
- achieve more efficient management of invoice payments and receipts through making intercompany payments early or late depending on cash and taxation considerations
- achieve tax efficiencies by as far as possible aligning profit favourably between high-tax and low-tax jurisdictions
- show one face to the customer

Note, however, that such centres can only deal with invoiced transactions, i.e. transaction exposures and so cannot deal with pre transaction exposures such as those arising from price lists in foreign currencies or quotes in a foreign currency.

Exhibit 2: Typical re-invoicing centre



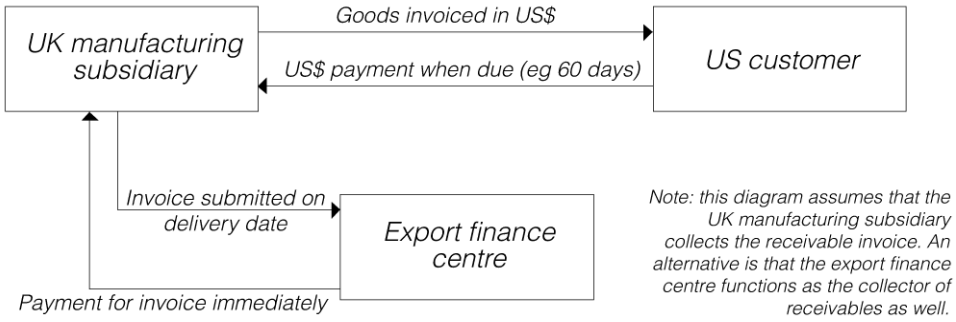
8 Export finance centres

Large multinational firms can often provide an in-house factoring facility for the group's export financing activities. This approach offers many of the benefits of the multicurrency centres as it centralises the management of FX exposures. Export financing centres operate very much like a factoring or invoice discounting business. They accept an invoice from a group operating subsidiary and provide cash immediately, less a market-based percentage. When the original invoice matures, the export finance centre may collect the cash direct from the customer or have it forwarded by the subsidiary when they receive it.

Export finance centres are used to replace external factoring / invoice discounting providers by assuming the credit risk internally. The group would be willing to take this on if customer exposure is diverse and if the treasury has sufficient liquidity (or can borrow at a low enough rate) to make a profit on this activity.

Compared to the other two international special purpose treasury operations, an export finance centre often requires much greater investment in terms of processing, credit assessment and collections capability – hence it is normally found in multinational firms which have manufacturing and sales operations widely dispersed. Because of its ability to function in much the same way as a factoring or invoice discounting business, it is often managed as a distinct profit centre in the group.

Exhibit 3: Typical export finance centre



9 Financial intermediaries

Financial intermediaries are introduced typically for tax purposes. They stand between the operating subsidiaries and the parent with the objective of optimising remittances to the parent.

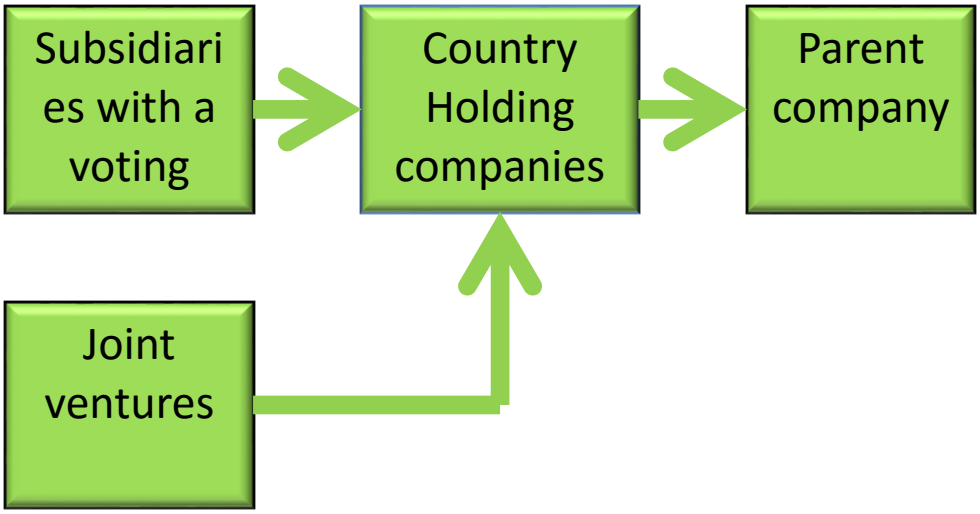
Exhibit 4: Financial intermediaries

Use favourable tax structures to optimise amount and timing of flows to the parent

'Optimising' usually means minimising tax at group level and managing the delays/timing differences between local remittance of cash and payments on to the parent.

Another example of a typical structure could include the following:

Exhibit 5: Financial intermediaries



Controlled subsidiaries (i.e. those subsidiaries where the parent can influence the timing and/or amount of dividends, either through voting rights or culture) pay their dividends into a 'reservoir company' (which by definition must also be their holding company), probably on a per-territory basis. Joint venture dividends may not be wholly controllable, so may flow at inconvenient times. If 'upstream loans' are permitted, the reservoir company can lend its aggregate balance back to the Parent (or elsewhere) until it declares its own dividend; but only one intercompany loan agreement is needed rather than one per subsidiary. Also, this reduces the number of cross-border flows to one, from one per subsidiary.

Treasurers must take care when implementing financial intermediary structures. There is the risk of challenge by tax authorities. The benefit must exceed the cost both of establishing the structure, and of unwinding it when it eventually becomes out of date.

10 Disadvantages

It is quite easy to get carried away with the advantages of these tyes of structure and advantages there certainly are, but they can be hard come by and we must consider some of the opposing arguments. The main disadvantages of these types of treasury structure are:

1	Complexity	While some of these ideas are simple in concept, they increase the overall complexity of a group, by focusing transactions through one entity or organisation.
2	Fragility	With everything happening in one place, there is little redundancy in systems and a simple failure can have very wide repercussions. The natural tendency to use one provider for economies of scale magnifies this concentration risk. Business continuity becomes a very significant issue.
3	Inflexibility	Structures designed for pure efficiency tend to work best when the users are stable, have stable and repeated volumes and activities. Introducing a new subsidiary from acquisition, or removing one following a disposal, can take enormous amounts of time. In addition, any external pricing seen in a

		tender, if the services are outsourced, will have been based on one volume. Any change to this volume will cause inefficiencies to staffing and pricing models and therefore tension in the whole arrangement.
4	Staff	There develops a huge dependency on certain staff who become crucial in these processes. This can increase the risk of fraud and mistake.
5	Accounting	All these transactions have to be accounted for, automatically, across different currency ledgers and brought back to one reporting currency. This is inevitably complicated. The centralising bulking of these transactions and the extra deals, such as short term currency swaps, add to this complexity.
6	Tax	Intercompany transactions will increase with these arrangements, even if there is only a service element charged for in the centre. This will attract the attention of the tax authorities who will naturally suspect that tax minimisation is a key element of any design.
7	Language	However much English become the lingua franca of the business world, not everyone will be competent in it and there will be misunderstandings. Cultural behaviour will add to the confusion here.
8	Implementation	This always takes longer and costs more than you expect and is also disruptive of other activities.

11 The impact of regulation

The improvements described here were on the back of initiatives designed well before the financial crisis when banks were still global and there was much competition for this type of global business.

While bank models are still settling down, some key themes do seem to be emerging, one of which is that in banking at least, it is not such a global market as it was. The number of global banks who could service all the business world wide is shrinking and these vehicles arguably depend on exactly that type of bank. In addition, there is not the unlimited support for international operations from regulators so that a company might find itself dealing with a very risky bank subsidiary or branch which is not supported by its country sponsor. For example, the United States has rules for how foreign creditors of the non US branches of US banks are not as favoured as the US branches. This follows from the fact that countries wish to support their own creditors more than foreign creditors.

In addition to this, as credit ratings of banks have fallen, there is a higher risk of concentrating activities with one bank.

These factors will tend to weigh against centralisation of activities in treasury.