5.2.1 Treasury Organisation

Unit: Unit 1 – Treasury Strategy

Module: Module 5 – Treasury structure

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Summary: A detailed look at all the choices that are available in treasury design, such as role, authority, response to risk and organisation

Keywords: role, authority, response to risk, organisation, functional, divisional, matrix, export credit agency, value added, outsourcing, visibility, transparency, execution

Contents

1 Introduction 1
1.1 Corporate level changes 1
1.2 Finance / treasury level changes 1
2 Models for treasury organisation 2
3 The role of treasury 4
3.1 Advisory role 5
3.2 Agency role 5
3.3 In-house banking role 6
3.4 Corporate demergers, rationalisation 8
4 Treasury authority 8
4.1 Central policy, local execution 13
4.2 Centralised execution 13
4.3 Regionalised execution, centralised policy 14
4.4 The road to centralisation 15
4.5 Balanced (in between) 16
5 Response to risk 17
6 Treasury organisation 21
6.1 Elementary treasury organisation 22
6.2 Intermediate treasury organisation 23
6.3 Advanced treasury organisation 23
6.4 Non-wholly owned subsidiaries 24

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Learning outcomes:

1. Treasury structure is often pragmatic in design, but models exist to allow us to analyse where a treasury is and where it might go.
2. This syllabus adopts a model involving role, authority, response to risk and organisation, with identifiable steps along each of these dimensions.
3. Change will originate from many directions, including corporate events and external influences, as well as internal and personal issues. The credit crunch and its regulatory and economic fallout are major influences.
4. The role of treasury has identifiable steps of advisory, agency and In House bank.
5. Treasury authority has dimensions of decentralisation, centralisation and balance between the two, with many treasuries both centralised and decentralised in some areas or by geography. There are many influences on this including developments in technology, banking products and regulation. Other influences include company size, industry norms, nature of cash flow, geography, culture, technology, location of expertise and need for control. The road to centralisation has many steps, including the use of specialist treasury vehicles.
6. Response to risk has dimensions of cost centre, cost saving centre and profit centre (increasingly value added centre). These can be identified in approaches to hedging.
7. Modern firms can be very complicated with many different interactions and levels of interaction.
8. Treasury organisation can be identified along dimensions of elementary, intermediate and advanced.
9. Special care needs to be taken with non-wholly owned subsidiaries.

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1 Introduction

It is difficult to be prescriptive about finance / treasury organisation structures because there are no rules-based models to draw on.

It is useful to understand the history of corporate treasury as this can give insight into the changes that corporations have been reacting to in their construction of treasury departments.

1.1 Corporate level changes

- Many 'developed economy' companies (and banks) developed internationally during the days of empire and enjoyed protected markets and a stable currency.
- US companies and banks expanded overseas during and after the 1950s as US influence increased after World War 2, challenging the supremacy of the older international businesses. This new competition prompted re-organisations designed to shift the emphasis from production to marketing.
- In the 1980s and 1990s Japanese companies and banks used their financial and industrial muscle to emulate the US, now followed in turn by those from the BRIC countries although only China has really seen any success internationally and in the 2010s all but China have arguably not fulfilled the expectations held.
- Currently, to create shareholder value businesses are reversing earlier policies of diversification and focusing instead on one or a few core businesses to create and enhance sustainable competitive advantage. Often, this means becoming a global player and building a global presence in a particular industry, and has provoked some large-scale mergers and divestments e.g. Glaxo and SmithKline to form Glaxo SmithKline, Cadbury Schweppes' demerger into Cadbury and Dr Pepper Snapple, followed by Kraft's takeover of Cadbury, SAB and Miller Brewing Company to form SABMiller[1]. So there is a trend today in the larger businesses towards a narrower market focus and wider geographic spread, the latter perhaps requiring investment in high growth less developed / more exotic countries and forcing a compromise between centralisation to ensure that strategy is not diluted and decentralisation to ensure that local variety is acknowledged and taken into account.
- This corporate activity often means that well established treasuries are broken up and new ones often have to be established (particularly in private equity / flotation situations) or expanded quickly with acquisitions, when perhaps a better practice in an acquired business is adopted inside the acquirer.

1.2 Finance / treasury level changes

- The development of global euro-currency markets in the 1970s and consequent availability of finance for overseas investment.
- The continuing development of financial instruments and globalisation of financial markets during the 1980s e.g. growth of derivatives such as swaps, which made it possible to manage many more financial risks but which also required much better expertise / systems to implement and control.
- The easy availability of bank facilities in centralised locations such as London and New York, allowing centralised treasuries to act as In House banks within their group.

[1] And possibly even further with its acquisition by AB InBev

- The long term effects from the fall out of the late 2000s financial crisis will affect the design and capabilities of treasury departments. Some significant factors include:
    - The financing landscape. This has changed dramatically for corporations, with banks in more or less secular decline as increased regulation leads to dramatic shrinking of their balance sheets and of their ability / willingness to lend. This leads treasurers to seek other lenders, potentially in centres away from the current major players such as London, New York etc. But note that in the mid- 2010s there are very large amounts of liquidity available in many lending markets, although there is debate about how long this might last.
    - This will also affect other products offered by banks, such as in cash management and derivatives.
    - There is more likelihood of financial services becoming more locally provided if banks favour their own nationals as borrowers.
    - Bank resolution procedures[2] which again become regionally focused, leading to more local supply of financial services.
    - Treasurers are likely to have to deal with many other kinds of counterparty, from Export Credit Agencies, to credit insurers and many different sorts of lender.
    - The increased volatility of prices in many financial and commodity markets should lead to a heightened interest in approaches to risk management in those areas.
    - Regulation in both banking (Dodd-Frank and Basel III) and other areas in financial services (Solvency II) may well affect the corporate landscape, where Solvency II affects insurance companies and pension schemes.
    - The weakened financial services sector and its implications for counterparty credit risk on investments and derivatives.
- The sovereign debt crisis, hitting the western world and in particular Europe in 2011, shows the fragility of institutions and which may still not be fully run.
- Brexit and the possible withdrawal of the UK from a broad international role, including the financial services in the City of London.
- The continuing very low and negative interest rates, broadly reflecting a lack of saving by populations dominated by an ageing cohort.

2 Models for treasury organisation

Treasury structures will be as varied as the business strategies which they support, although we may come to expect some similarities between treasuries in the same economic sector and of the same size, although this is not universal.

Despite the lack of rule-based models for treasury organisation, there are some descriptive models and generally accepted dimensions of organisation which at least provide a vocabulary for discussing treasury organisation. We will use four dimensions of treasury:

- role
- authorities
- response to risk

[2] Resolution is the process of re-organising a bank in difficulties. Procedures tend to be national (or European), forcing bank models into national silos.

- organisation

These four dimensions of treasury are shown in the matrix in Exhibit 1; they are interdependent and overlap. For instance, profit centre treasuries are likely to be centralised and to act as in-house banks. In Exhibit 1 the matrix has been adapted as a planning tool, providing an easy-to-use template for profiling an existing treasury, for management of an existing treasury by understanding its role, or (by ticking the boxes in each category) for deciding on the ideal profile in the future. This matrix is a common accompaniment to examination questions.

Exhibit 1: Treasury organisation profile (1)

ROLE	Advisory	Agency	In House Bank
AUTHORITIES	**Decentralised**	**Centralised**	**Dynamic balance**
RESPONSE TO RISK	**Cost centre**	**Value added** **Cost saving centre**	**Profit centre**
ORGANISATION	**Elementary**	**Intermediate**	**Advanced**

In addition to the four dimensions outlined above, there are two features of corporate organisations that are empirically observable. The first is that as businesses grow and/or become more complex (e.g. more processes, products, markets, countries, internal relationships) the organisational structure changes – "functional" to "divisional" to "matrix" is the classic pattern. These changes in the corporate organisation are often paralleled by shifts from "elementary" to "intermediate" to "advanced" in the finance/treasury organisation. The second observable feature is that significant shifts in the macro-environment may provoke major organisational developments or adjustments across whole classes of businesses.

These two features mean that corporate organisations and their finance/treasury functions are continuously responding to a wide range of influences, some the result of internal decisions and others imposed on the business by external forces beyond its control. Here are some examples of macro – environment changes.

The Treasury Organisation Profile can be sharpened by adding in the additional dimensions shown in the exhibit below.

Exhibit 2: Treasury organisation profile (2)

Dimension			
Role	**Advisory**	**Agency**	**In House Bank**
Authorities • Shared service centre	**De-centralised**	**Centralised**	**Balanced**
Response to risk • **Thinking** ○ **Accounting** ○ **Economic** ○ **Probabilistic** ○ **Portfolio**	**Cost centre**	**value added / Cost saving centre**	**Profit centre**
Organisation	**Elementary**	**Intermediate**	**Advanced**

• **Structure** ○ **In house** ○ **Outsource** • **Culture** ○ **Debt** ○ **Equity**	(ignores group efficiencies)	(exploits group efficiencies)	(compromises with complexity)

Notes:

- Shared service centres, where group wide processing is carried out in one location, e.g. India or Eastern Europe, is a form of centralisation.
- "Value added" is beginning to replace "profit centre" as a more appropriate treasury goal.
- The concept of thinking about risk in accounting, probabilistic and portfolio terms has been increasingly used in treasury and reflects modern approaches to risk measurement (see Unit 1 Module 4).
- Outsourcing is dealt with elsewhere in this module.
- Debt / equity culture describes how the board and senior management think about funding. Boards of investment grade companies tend to take funding for granted. When such companies stray into non investment grade territory the treasurer sometimes has difficulty communicating the difficulties in raising finance. Utilities will certainly have a debt culture, as will transport companies (actually a leasing culture). Technology companies will have an equity culture.

We examine each of the four dimensions in turn in the next sections.

While we major on the organisation profile shown in Exhibits 1 and 2, this model is not the only one. One of the Big 4 consultancies has suggested the following model:

Exhibit 3: Treasury evolution

	Stage 1	Stage 2	Stage 3	Stage 4
Operational	Information processor	Data flow manager	Business partner	Change agent
Primary focus	Transaction flows	Policy and procedures	Concept introduction	Value added initiatives
Success measure	Transaction settlement	Timely & costs effective execution	Supporting company / business objectives	Driver of shareholder value
Key challenge	Volume	Bureaucracy	Acceptance	Leadership

Source: Ernst & Young, International Treasurer

3 The role of treasury

Advisory, agency, in-house bank are three widely used labels for distinguishing between the different roles for treasury. Each of these roles requires a different set of skills and management style in order to be effective. Treasuries tend to evolve from advisory to agency

and less frequently to in-house bank, although probably only some activities could properly be described as those of an in-house bank.

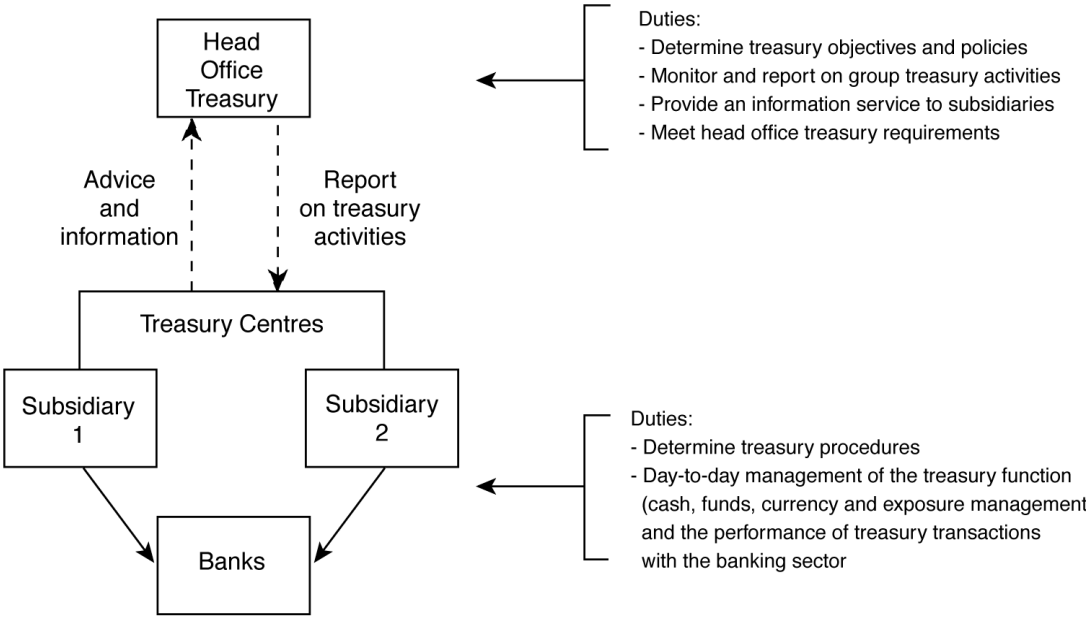
3.1 Advisory role

A group treasury would function in this capacity if financial decisions were delegated elsewhere in the organisation. This type of role is most often seen in decentralised organisations.

The activities involved in undertaking such a role would include:

- setting treasury policies and objectives
- developing reporting and monitoring systems
- offering a central source for financial market information
- advising treasury operations on best action under various circumstances
- managing head office / central treasury requirements

Exhibit 4: Advisory role



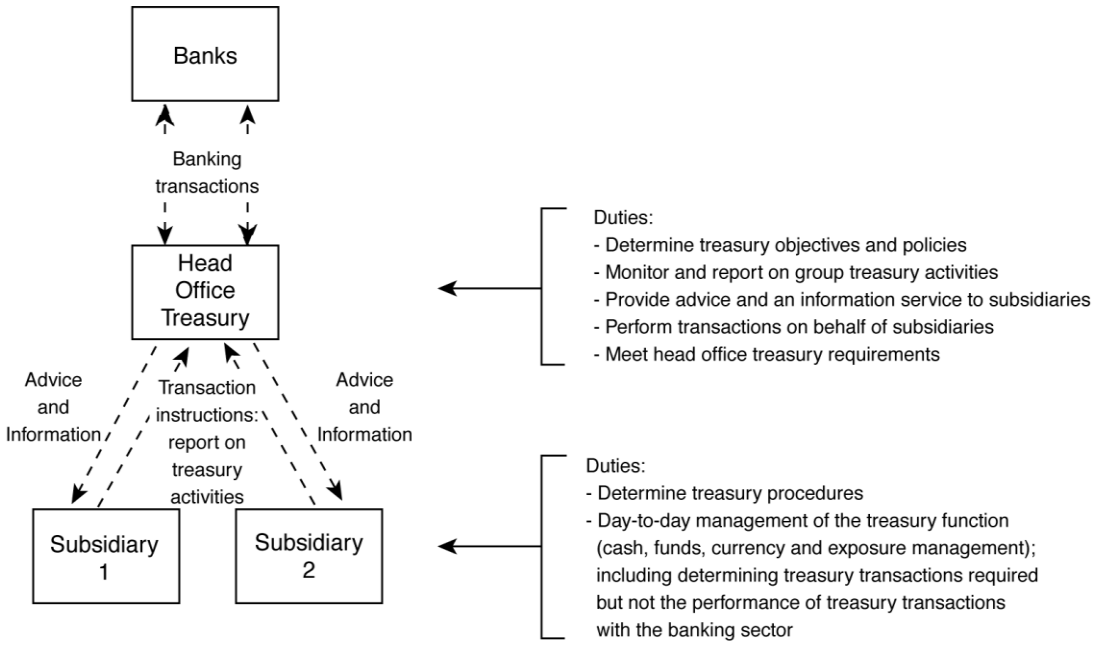
The advantage of maintaining a group treasury advisory function is that the cost of maintaining specialist expertise can be allocated among all of the various treasury operations - thus avoiding duplication of expertise.

3.2 Agency role

Simply put, the agency role maintains delegation of treasury decisions to the local level, but requires that all external financial transactions be conducted through the central treasury - which functions as the ‘agent’ of the various treasury operations.

Day-to-day management of local treasury remains at the local level. This includes determining which treasury transactions are required locally. However, once the decision as to what is required is made, it is referred to the central group treasury to carry out any transactions on their behalf. This can be a legal arrangement so that deals are in the name of the operating company or it could be as a 'virtual' agent where deals are in the name of the parent / treasury company and transaction records managed only in management accounts[3].

Exhibit 5: Agency role



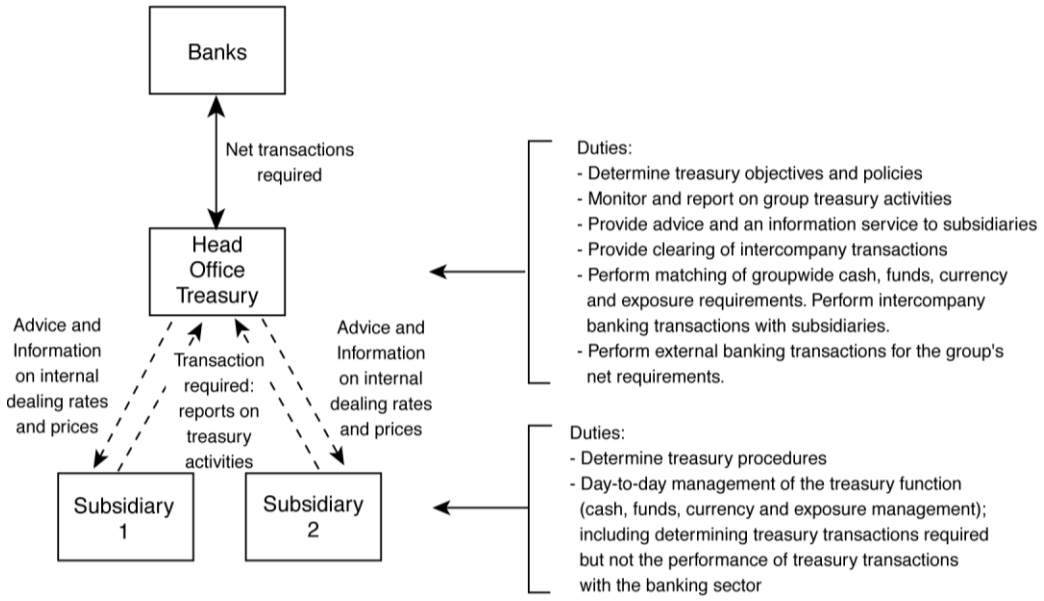
The group treasury essentially manages the bank relationships for all the subsidiary companies. The advantage of such a structure is that due to its increased market presence and more experienced personnel, the group treasury can normally achieve better rates and lower costs through centralised dealing.

3.3 In-house banking role

The next evolutionary step is the in-house bank (IHB). In this scenario, the group treasury functions as the sole bank with which the subsidiaries can deal. Treasury decisions remain at subsidiary level, and the group treasury provides as many 'banking services' (providing cover, taking on exposures) as desired. Group treasury prices its services as it wishes (consistent with transfer pricing regulations) and then decides what hedging action it should undertake to safeguard the consolidated position.

Exhibit 6: In-house bank role

[3] This can lead to disadvantages in tax if gains and losses on instruments do not sit with the correct group company.



The ability of a treasury operation to function efficiently in this manner is conditional on a number of key factors being met:

- sufficient volume of financial transactions to make the investment worthwhile – in both people and systems
- high level of central expertise to run the IHB
- appropriate standing within the group and with tax authorities so that business can be transacted at appropriate rates. This will avoid the need for debate over transfer pricing rules and should allow local management to achieve better (or at least, no worse) pricing compared to the same business transacted with external banks on their own account, e.g. inter-company loans compared to external loans.

This role provides for the day-to-day management of treasury requirements to be conducted as close to the business as possible, yet is centralised in that exposure and settlement netting, financial products and funding required are controlled by the central treasury operation. In addition, it is normal that the central treasury would also conduct all major investment and financing transactions for the group by keeping the optimal debt / equity ratio in mind.

The advantages of this approach are:

- the group can benefit from improved rates and prices due to larger concentrations of external transactions
- concentrating transactional requirements at the centre may open up opportunities to access new markets such as commercial paper programmes
- settlement netting maximises the efficiency of cash and funding utilisation and minimises transactional banking fees
- group treasury becomes more ‘profit-conscious’ rather than cost focused

Disadvantages of too profit-centred an approach are that the in-house bank, in a bid to increase its profits, may overcharge its ‘captive’ clients. There is also the temptation to leave a position un-hedged in an attempt to speculate for an improved return. Staff may also take

their eye off the clients, concentrating too much on their own profit making. These disadvantages should be addressed through the firm's tax planning, policy and control frameworks.

3.4 Corporate demergers, rationalisation

One bonus for companies that decide to radically refocus on a single core business is that they may end up with a much simplified finance/treasury structure. In the extreme, it may be possible to manage all treasury activities from the centre, although any significant degree of geographic diversity will inhibit this.

4 Treasury authority

There has been a fairly relentless trend over the past 20 years or so for increased centralisation of some or all of their treasury functions. In the 1980s it would be common in a company quoted in a country to locate its treasury in that same country, which would probably be managing cash domestically only and having frequent conversations, but no more, with their counterparts overseas. That same company in 2010 will locate its treasury wherever it is most efficient on a post-tax basis; the treasury will be managing cash and financial risks for its US and European operations and probably many other countries as well. There are several reasons for this:

Developments in technology

Enterprise resource planning (ERP) systems, treasury management systems (TMSs) and internet capabilities mean that even smaller companies can contemplate using centralised vehicles such as payment factories, shared service centres and In House Banks

Banking technology

It has become increasingly easy to have access to bank accounts worldwide, both for balance reporting and payment initiation. The potential need for multiple banking systems in one place becomes a limiting factor, but the corporate use of SWIFT may accelerate centralisation even further.

Banking products

Banking products have, possibly at the request of the largest corporate clients, become more suited to 'life at the centre', so that banks prefer one (cheap to run) main relationship with the parent rather than lots of local relationships. Lending / derivatives are to the parent and then on lent / on provided by the parent rather than provided locally. Products are usually cheaper and simpler this way.

Note that changes in banking since the financial crisis have put this 'bank supermarket' model under threat.

Regulatory environment

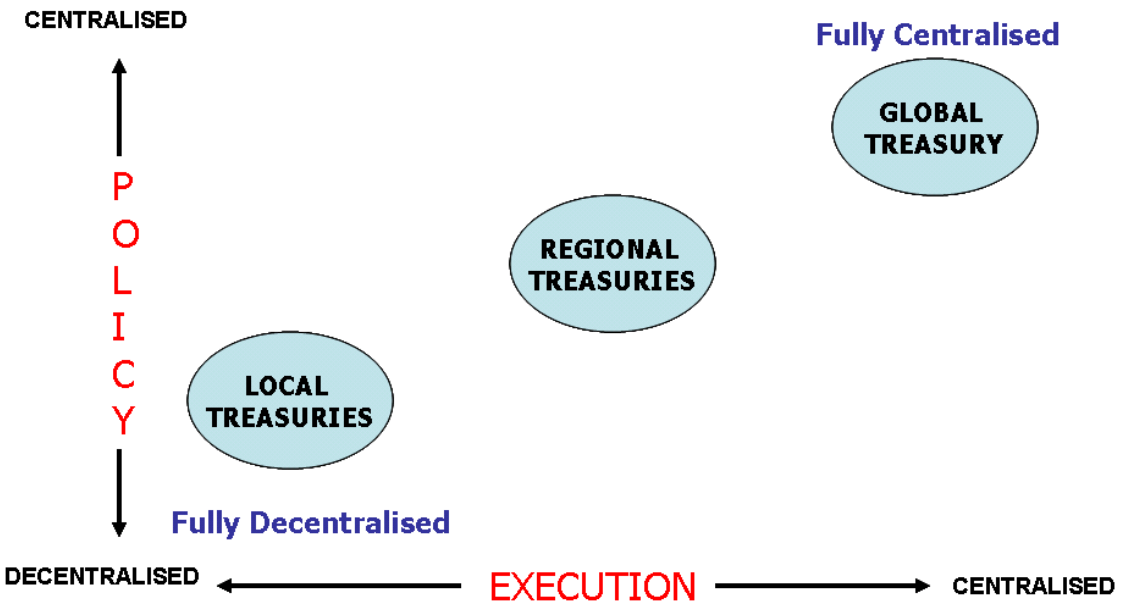
Thanks to Sarbanes-Oxley (and its equivalents) companies need to demonstrate good governance. Treasurers of international companies need to find structures that will give them greater control over treasury activities.

Centralisation however, can be accomplished on a number of different levels:

- on a geographic basis, by region or by country
- by product line or business division
- by customer type, e.g. corporate or consumer, wholesale or retail
- by function using vehicles such as shared service centres and payment factories
- by activity – e.g. borrowing and interest rate risk management may be centralised, but foreign exchange risk management decentralised.
- through execution with outsourcing
- in policy making, but with decentralised execution

No matter how compelling the financial arguments in favour of centralisation, there can be many reasons why companies choose to remain wholly or partially decentralised. Centralisation or decentralisation is not an 'either / or' decision and companies can find themselves anywhere along the spectrum from one extreme to the other, with some elements centralised and others not. Exhibit 7 illustrates how treasuries can be organised on two major parameters, policy making and execution.

Exhibit 7: Degrees of centralisation



This does not mean to imply that all global treasuries centralise policy and execution. Some may choose to centralise only the policy making, or only the execution, through an in-house bank. Some local treasuries may also use a shared service centre to consolidate some treasury functions. Exactly how a company chooses to structure its treasury will depend on a number of factors:

Size of the company

Bigger companies can support a larger centralised staff (and systems) in support of treasury and allow for greater segregation of duties.

Industry norms
Some industries are more conducive to a centralised treasury, such as those which are largely in sales distribution, e.g. software companies, rather than those that are heavily into on-the-ground manufacturing processes. How competitors are structured and whether that provides them with any competitive advantages or disadvantages may also influence the decision.

Nature of cash flows
Electronic flows are easier to centralise than paper flows; retail cash or paper receipts are usually more efficiently handled in a decentralised structure.

Geographic distribution
It may be harder to centralise widely dispersed operations. Time zone differences, communications issues and legal structure are all issues than can favour (partial) decentralisation. There may also be operations in certain areas of the world where local regulations inhibit centralised treasury management, such as exchange controls and lack of convertibility.

Need for control
Sometimes there are overriding company-wide issues that determine how the treasury function will be organised. Today, in the Sarbanes-Oxley environment there is much greater emphasis on the need for information, reporting and control. Compliance is easier to ensure in a centralised organisation, always assuming that centralisation is effective and subsidiaries do not go off and do things that the centre is not aware of.

It is important that the structure that is implemented supports both treasury and corporate objectives.

Bearing the above factors in mind, the organisation also needs to support the strategic role of group-wide treasury and its major objectives which might include:

- obtaining visibility and optimum control of risk
- obtaining visibility and optimum control of liquidity
- facilitating business expansion
- optimising procedures by automating processes where possible
- maintaining security of principal

While recognising that very few companies are either fully centralised or totally decentralised the advantages of each structure for an international company can be summarised as follows:

	Centralised treasury	**Decentralised treasury**
Corporate governance and control	• More transparency of information globally • Co-ordinated centralised treasury policy • Consistency of approach in measuring, monitoring and managing the company's	• Greater level of detail available on individual transactions • Easier reconciliation of any reporting discrepancies • More local level accountability/ responsibility/

	Centralised treasury	Decentralised treasury
	exposures • Procedures and documentation can be standardised • Improved control and reporting • Better position to prevent fraud • Authorities (bank account mandates etc) can be centrally controlled	ownership of results
Management	• Less duplication of treasury systems and staff • Can create a centre of excellence to provide expertise and assistance to other units	• Financial targets more meaningful for local units • Staffing levels can be kept low • Higher local level co-operation
Cash / liquidity management	• Centralised information reporting is more timely, accurate and reliable • Cross-border payments and collections can be handled more efficiently and less expensively • Improved forecasting • Economies of scale by netting / aggregating funds	• Can match local business needs more closely • Better, more detailed information about local cash flows • Local payments and collections likely to be more efficient and acceptable to local beneficiaries • Local knowledge and expertise in local cash management practices • Cut-off times likely to be more favourable • Attractive investment and funding options may be available locally but not available to non-residents
Funding	• Consolidation may result in better rates, terms and conditions • Debt terms can be standardised, allowing for easier compliance and monitoring of covenants	• Local companies may get preferential rates or access to grants or special loan funding • Non-residents may find local funding is restricted • Easier to handle documentation, local language, covered by local legal system etc.
Risk management	• Visibility of corporate-wide risk allows better overall control, information and risk management policy • Economies of scale can provide better pricing on hedging transactions	• Local treasury may be better able to assess local risks and can react faster to changes in exposure

	Centralised treasury	Decentralised treasury
Banking relationships	• Consolidation of business with core banks will improve relationships • Can negotiate consolidated pricing • Fewer banks used, so lower fees paid • Easier to maintain and administer fewer, larger relationships • Fewer electronic platforms to maintain and pay for (MT101s notwithstanding)	• Access to local banks, services and pricing • Enjoyment of de facto or real government support for domestic banks and businesses • More involvement / ownership by local staff • Local staff may get additional benefits from a local bank relationship • Local banks have local expertise • Easier communications • Better terms and conditions for local companies than for non-residents • Faster resolution of disputes
Bank relationships (cont'd)		
Systems	• Can leverage systems investment across the entire company • Easier to support from an IT perspective if all systems are on the same platform • Standardised platform will mean better communications, information and reporting • Can take advantage of centralised structures such as netting, shared service centres, payment factories etc.	• Stand-alone systems are cheaper to purchase and easier to maintain • Language / script issues more easily dealt with

The disadvantages of a decentralised organisation can be summarised in terms of lack of efficiency and loss of control, for example:

- inability to leverage economies of scale
- duplication of functions and staff
- many different systems to support
- cash management activities such as netting, inter-company lending, shared service centres, payment factories etc. may not be possible
- loss of visibility of information resulting in delayed, inaccurate, or incomplete reporting
- lack of control for risk and liquidity management purposes

Relationship issues, however, are the major drawbacks of a centralised treasury including:

- loss of autonomy and ownership of results by the business units
- local vendor and bank relationships will suffer
- need for increased communication and coordination with head office

- lower morale / lack of interest in operating units due to reduced responsibilities and concerns about job losses

The decentralised structure favours local results; the centralised structure benefits group interests. It is worth noting that few companies have a fully centralised treasury on a global basis, where both policy and execution are centrally managed; and even fewer allow *total* local autonomy. In reality, most companies fall somewhere along the spectrum of being partially centralised or decentralised, some activities being held at the centre and some delegated to local treasuries. Even companies with a central treasury function may choose to operate in a decentralised fashion. It is extremely difficult, however, to achieve the treasury objectives stated above without some degree of centralisation. Many companies centralise on one or two levels but not all. Some of the most popular structures are described in the following sections.

4.1 Central policy, local execution

This structure is used when it is important to retain some local autonomy but treasury wishes to apply control over policy. The group treasury sets guidelines and policy and instructs local staff to some degree. All actions and operations, however, are carried out by the local staff whom are likely to have a dual reporting line, both to their local management (often a controller) and to the group treasury. This structure has some advantages and a few drawbacks:

Advantages

- Major policy/strategy decisions are taken by head office based on a global view.
- Can take a holistic view of what is most efficient for the whole company.
- Actions are undertaken by local staff in the local markets.
- Outcomes are reflected in the operating companies' figures, which may simplify accounting, legal and tax issues.
- Local participation ensures the commitment of units to the group strategy.
- Keeps local banks happy as they retain the local business.

Disadvantages

- Group treasury becomes accountable for the actions of others, which it does not control.
- Group treasury is a cost centre and a central overhead and has to continually justify its existence.
- In spite of local participation, operating units may be dis-incentivised if they feel that they are simply 'following orders' with no opportunity to make an active contribution.
- Does not enable economies of scale to be realised. Deals cannot be offset or consolidated and units are free to select banks that they use.
- Decentralised dealing is more difficult to control and, in practice, it may prove impossible to monitor dealers' activities.
- Group treasury must rely on full local co-operation to receive regular and accurate reporting (e.g. forecasts, currency position reporting, identifying exposures, etc).

4.2 Centralised execution

By consolidating execution treasury is able to realise some of the benefits of economies of scale and use some of the cash management techniques which require a degree of centralisation. Centralised execution can be performed for a single function only, such as

using a payment factory or a netting centre, or for a range of treasury activities such as using an in-house bank (all of the individual structures will be described in more detail below). Obviously the greater the degree of consolidation the more benefits accrue to the group. This structure works with either centralised or decentralised policy making. Thus group treasury, by determining the scope of centralised execution and the decision-making process, has the greatest flexibility in determining how far it can achieve the overall benefits of centralisation. Using an in-house bank as an example, some of the benefits and disadvantages of centralised execution are summarised below.

Advantages

- Consolidated volumes enable real economies of scale and reduce the number of transactions with banks, bank margins and charges.
- Even applying arm's length pricing, group treasury can commonly provide subsidiaries with more attractive pricing than they would obtain from the local market.
- The information needed for centralised execution provides an excellent basis for other activities such as risk and liquidity management.
- The group treasury becomes a centre of excellence.

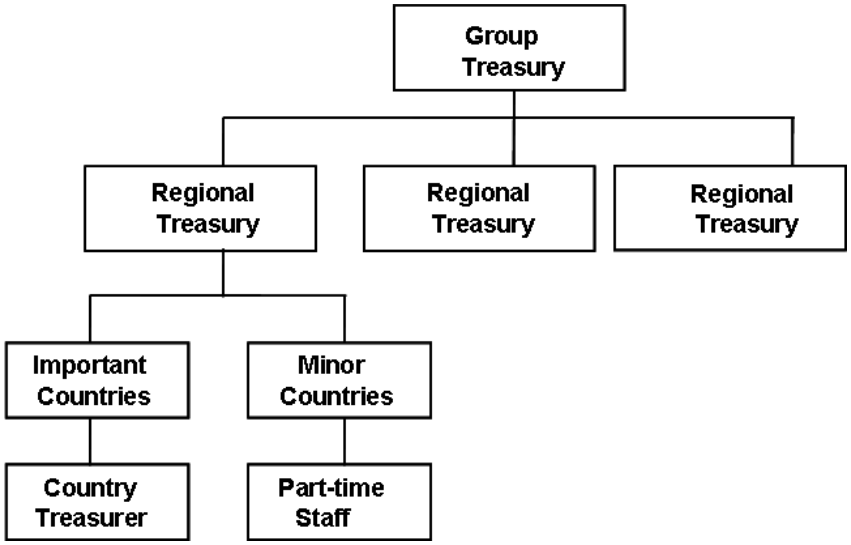
Disadvantages

- Group treasury still relies on local staff to:
    - Provide forecasts
    - Identify exposures
    - Co-operate and advise all input information
    - Execute transactions through the in-house bank as appropriate
- Local banks lose business.
- Reduces local involvement in some aspects of treasury, particularly day-to-day contact with banks, leading to a lack of commitment and ownership of the results.
- Requires investment in systems and communications

4.3 Regionalised execution, centralised policy

This model is favoured by some of the largest multinational companies, allowing a certain amount of autonomy at the regional level but co-ordinating the overall picture from group treasury. This two-tier approach allows maximum flexibility for regions to centralise or remain decentralised based on their needs. Regional treasurers are given guidelines and policies and then co-ordinate regional action with group treasury. Exhibit 8 shows a typical regional treasury structure where the group treasury is situated at the same location as the head office and regional treasury centres report into it. Important countries may have a full-time treasury resource reporting into the regional centre, but minor countries rely on part-time resources, staff often doubling as accountants, bookkeepers or controllers.

Exhibit 8: Typical regional treasury structure



The advantages and disadvantages of such a structure are summarised below.

Advantages

- Allows for maximum flexibility at the regional and local levels.
- Local expertise ensures regional treasury management is as efficient as possible.
- Local banks retain business.
- Risk & liquidity management co-ordinated at the group level.
- Local level retains responsibility and ownership of results.
- Central and local treasuries 'talk the same language' thus improving communication and intra-group service levels.

Disadvantages

- Global economies of scale may not be realised.
- Group treasury relies on regional treasuries to:
    - Provide forecasts
    - Identify exposures
    - Co-operate and advise input information
    - Execute transactions through the in-house bank
- May require extra staffing levels, investment in systems and communication.
- Multiple banking systems may still be required.

4.4 The road to centralisation

As we have mentioned, the trend has been towards centralisation, but it is rarely accomplished in a single step. Most companies prefer to progress through levels of increasing centralisation, as illustrated in Exhibit 9.

Exhibit 9: The road to centralisation

	Decentralised	**Partially centralised**	**Fully centralised**
Focus	Domestic transaction management	Making certain activities more efficient	Making the treasury function most efficient
Policy making	Local	Split between local and central	Central
Execution	Local	Central	Central
Treasury organisation and vehicles used	Local treasuries transact with local external counterparties	Use of internal vehicles: • payments factory • collections factory • in-house bank • netting centre • re-invoicing centre • in-house factoring • ASPs[4]	Use of internal vehicles: • in-house bank • shared service centre • regional treasury centre • outsourcing • treasury management centre

A group treasury function may be established long before the company is ready to fully centralise. It will, however, guide the company on the path toward centralisation, introducing structures and vehicles as they become appropriate

4.5 Balanced (in between)

In our treasury organisation profile in Exhibit 1, we refer to an ideal state where treasury is in dynamic balance. So essentially we should aim to centralise what is best centralised and keep local what is best kept local. This might involve the creation of regional treasury centres, perhaps the best of both worlds. While the trend has been to centralise authority, it is noticeable that in recent years those firms which are pursuing global spread and therefore have a greater variety of environments to manage are beginning to push some discretion back down to subsidiary level.

This seems to be partly a response to size and complexity and partly a desire to make subsidiary managers more aware of how their financing and risk management activities feed through to shareholder value, as measured by after-tax cashflow to the parent, dividends and equity capital growth.

We have labelled this arrangement “balanced” to underline its dynamic nature. The centre of gravity of authority will move between the centre and subsidiaries on the basis of a continuing dialogue about which party is best suited to make particular decisions.

This may, of course, be merely a temporary phenomenon as the centre adjusts to a step change in complexity. It is possible to argue that there is always a presumption in favour of centralisation and that anything else is merely a pragmatic response to a passing problem. However, there is a parallel between “balanced” authority and the “advanced” treasury structure.

[4] Application Service Providers

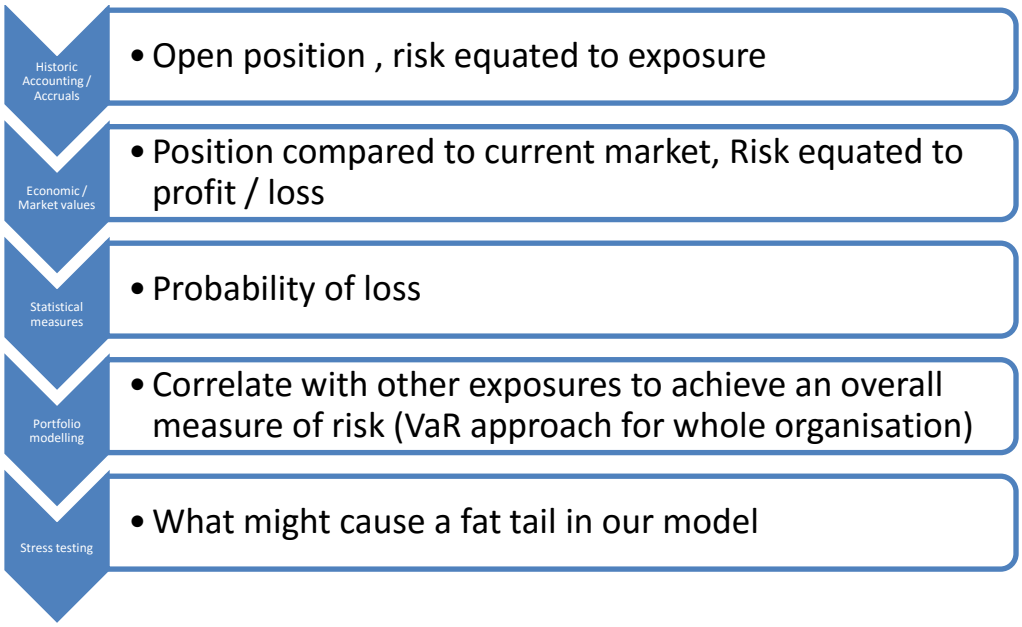
Another factor which might influence this debate is around fallout from the credit crunch. One of the reasons for centralisation is the ability to source financial services from one location. If that location (London or New York) is unable to provide those services, then localisation, or decentralisation, is inevitable. This applies to products as well as to overarching issues such as counterparty risk. It may be a mistake to place all the firm's cash management eggs in one basket, for example, if there is concern over that counterparty's ability to perform. Cash may be best diversified across many regions.

5 Response to risk

5.1 Approaches to risk

We start off here with the thinking behind how a treasury might respond to risk and then consider the three classic approaches. Recall the history of risk measurement for trading desks in financial institutions.

Exhibit 10: History of financial risk measurement to market exposures



When applying this to the thinking inside a corporate treasury, we can see the same progression:

An *accounting* approach would be broadly to react to actual positions supplied by operations and then treating that and that alone as the exposure.

An *economic* approach would then consider the materiality of these actual positons and reach conclusions about how important it is to actually manage each exposure. Small exposures could be ignored.

A *probabilistic* approach then brings in volatility so that the riskier exposures are managed, which naturally leads on to:

A *portfolio* approach, where the exposures are added and measured and responded to all as one, taking into account correlations and risk appetite.

While these approaches are a hallmark of maturity and presage treasury evolution as seen in exhibit 11 (exhibit 3 repeated) they lead in turn to what then might be rather simplistic consequences.

Exhibit 11: Treasury evolution

	Stage 1	Stage 2	Stage 3	Stage 4
Operational	Information processor	Data flow manager	Business partner	Change agent
Primary focus	Transaction flows	Policy and procedures	Concept introduction	Value added initiatives
Success measure	Transaction settlement	Timely & costs effective execution	Supporting company / business objectives	Driver of shareholder value
Key challenge	Volume	Bureaucracy	Acceptance	Leadership

Those consequences require treasury to operate by some method and be measured along the same guidelines. This is one of three classic responses as outlined below.

5.2 Responses to risk

Exhibit 12: Responses to risk

Policy statement	Treasury response: action / characteristics		Management accounting description
Hedge 100% i.e. hedge where possible	Passive	Risk Averse	Cost centre
Selective hedge i.e. hedge & manage	Active	Risk Averse	Value added centre / Cost saving centre
Take Positions i.e. hedge, manage & trade	Active	Risk Preference	Profit centre

The treasury response will be influenced by factors such as:

- risk appetite, as defined in board policy
- competitive position and industry practice
- materiality of risks
- period of exposure

- volatility of outcomes
- expertise to assess risk, arrive at a view, execute deals
- control system quality

The *cost centre* approach is to minimise the impact of financial volatility and go for immediate certainty of outcome rather than to "take a view" or to "manage a position" by leaving it open and monitoring events.

However, this is not as simple an approach as it might at first seem. For instance, currency transaction exposure exists with certainty, and can be hedged with certainty, only for firm orders (and even these may be cancelled). So, if certainty is the goal, what about probable orders or expected trading volumes over the budget period?
Cost centre treasurers will commonly specify a hedging level corresponding to level of certainty, such as:

- Firm orders 100% hedge
- Highly probable orders 75% hedge
- Probable orders 50% hedge

The *value added* approach is about bulking up transactions and centralising expertise to achieve savings. Thus an inter company netting arrangement bulks up foreign exchange transactions and cross border payments so that savings are made without taking on extra financial risk. Similarly, financing can be made in the centre cheaper and loans made to subsidiaries rather than expecting subsidiaries to arrange their own finance. Each of these activities has extra cost in terms of systems and people which should be more than compensated by the savings made (hence value added). Value adding centres (or perhaps profit conscious cost centres!) require higher quality expertise and control systems than do cost centres. So the benefits need to exceed the extra costs. This type of approach could also be called a cost saving approach.

Once treasury takes on additional financial risk, it becomes strictly a profit centre – i.e. its role becomes one of generating profit from favourable movements in market prices. At the least risky level, treasury may maintain a view about financial market movements and to exercise it by leaving a proportion of exposures un-hedged – within strict limits - in order to take advantage of favourable price movements[5]. This requires continuous monitoring of exposures so that adverse movements can be anticipated and countered, and also protection against adverse moves. For instance, in the foreign exchange markets this can be achieved by intelligent use of "take profit" and "stop loss" orders, which crystallise outright transactions if set levels are achieved in the market.

The *profit centre* approach can involve taking on substantially more risk, by deliberately assuming speculative positions in addition to managing (perhaps exploiting) underlying ones. This role implies that treasury is a line function rather than a support function, and is rare in corporates. Entities which actively trade the financial markets tend to place such trading activity in tightly controlled specialist areas, often outside the core treasury. Banks are an

[5] But beware betting against the market, which in theory knows best.

example of this. They will have traders taking usually short term positions and then a more dedicated treasury team controlling overall risk and exposures, together with funding and liquidity. It is a matter of semantics as to whether traders are defined as part of treasury or not (a wider definition of treasury may include them) but the controls over them will be very tight. Similarly, airlines may have specialist units which trade jet fuel, electricity companies may trade electricity, and so on; but in each case these activities are again tightly controlled, performed by specialists, and generally separate from 'treasury'. Most such profit centres are in businesses which are large scale users of commodities (fuel, oil, sugar, cocoa etc) and which therefore have a tradition of dealing and managing such commodity positions; and of course tend to be larger companies with an abundance of capital.

5.3 Treasury and the rest of the organisation

However, this is more complicated than it appears. The classic responses deal with how to manage treasury but do not deal with the service that treasury gives to operations for the management of the financial risks of trading.

In an accounting approach the service to operations is clear, hedging is provided to them to suit their needs. Treasury can respond by just arranging the deal (as a cost centre), seeking better efficiencies and pricing (as a cost saving centre) or take bets (as a profit centre).

What service is given to operations under an economic approach? In this situation the operation wants a hedge but treasury says it is not worth the effort?

What service is given under a probabilistic and portfolio approach? In this situation the treasury may be executing global hedges which manage overall risk but the operation might still want a hedge for its exposure[6].

This will of course be very different for different organisations and depends on size and where risk lies. However, because pricing policy cannot be separated from risk management, then treasury should be an element of line management. There are no right answers.

Example 1: Airline fuel risk management

Etihad Airways has a long history of hedging airline fuel and at times has probably been the biggest hedger in the sector. The hedges are held in Group Treasury and are completely separate for the operational management of the airline. Hedges are made to manage overall risk to the firm.

American Airlines also had a history of hedging fuel with decisions taken at treasury level with significant board and committee input. The fuel price achieved in hedging was passed back to operations. However, operations then became less efficient at saving fuel and making pricing decisions because responsibility had been removed from them. The 'hedging tail was wagging the decision making dog'.

[6] This approach also has tax consequences

6 Treasury organisation

When discussing corporate organisational structure, it has been suggested that number of products, number of markets and interdependence of businesses largely determines the type of structure.

Applying this idea to treasury, it is clear that as we move from single country, single product companies to multi-national, multi-product, interdependent business companies, the financial and business risks rise dramatically and the level of complexity may get beyond the centre's capability to manage.

Exhibit 13: Type of business and complexity of risk

Type of business	*Financial risks*	*Business risk*
single country • single market product	**1 x interest** **1 x tax** **1 x legal**	**1 x revenue** **1 x profit**
multiple country • independent product markets	**n x interest** **n x tax** **n x legal** **n x currency** **n x political**	**n x revenue** **n x profit**
• interdependent product markets	**n x interest** **n x tax** **n x legal** **n x currency** **n x political**	$n\frac{(n-1)}{2} \times \text{revenue}^1$ $n\frac{(n-1)}{2} \times \text{profit}^1$

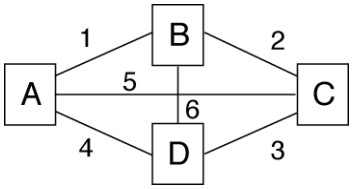
Note: "n" is the number of countries, entities or whatever. If n = 4, there are 6 inter-relationships possible; if n = 10, there are 45.

In the above exhibit there are five major financial risks associated with multinational activity: differing interest rate structures, tax regimes, legal and regulatory systems, currency considerations (both rate and exchange controls) and political framework. The direct business risks are local levels of revenue and profit: the associated financial risks need to be managed so the planned cash flows to the parent are protected. The greater the extent of transactions between subsidiaries then the more complex this task becomes.

For instance, a "single country / single product market" business will have one set of interest rate, tax and legal risks to manage, together with one set of revenues / profits at risk.

A business operating in several ("n") countries, but with no trading between subsidiaries, will have "n" interest, tax and legal sets of risks to deal with and in addition, currency risks and political risks, as well as "n" sets of revenues / profits at risk.

For a business operating in several countries but with significant levels of trading between subsidiaries, there are many more possibilities for risk to arise because there are many more possible relationships: e.g. for four countries there are six possible sets of relationships.



Channon & Jalland[7] proposed three types of international treasury structure, based largely on the idea of number of products, number of markets and interdependency. Although published in 1979 nothing better seems to have appeared in the meantime. The three types are:

- elementary
- intermediate
- advanced

These are described below. There are strong parallels between these three types and decentralised, centralised and balanced authority structures. There are weaker parallels with advisory, agency and in-house bank roles.

6.1 Elementary treasury organisation

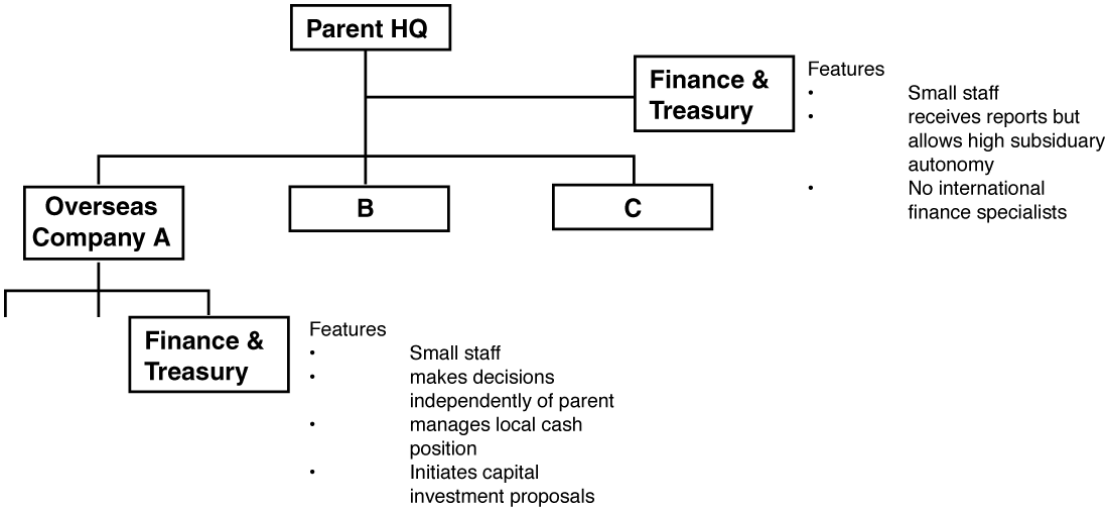
Usually found when:

- Low level of cross-border activity (10 – 20% total revenue; 6 - 12 countries)
- Little or no intercompany trading across geographic borders

Characterised as 'ignoring potential financial efficiencies'.

Exhibit 14: Elementary international treasury organisations

[7] Channon & Jalland (1979) *Multinational Strategic Planning*, Macmillan (pp 121-129).



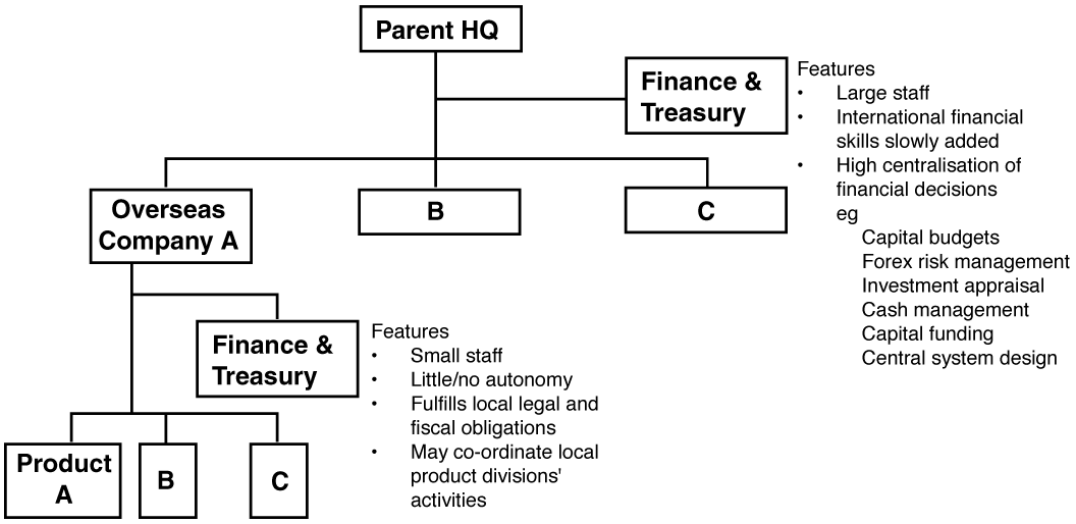
6.2 Intermediate treasury organisation

Usually found with:

- Modest levels of international activity (15 - 40% total revenue) and some intercompany trading.
- All forms of international organisation and commonly with international divisional structure.
- Often installed after a serious international financial problem with subsidiary.
- Corporate financial staff responsibility for both domestic and international operations. Typically no global financial planning.

Characterised as ‘exploiting potential efficiencies’.

Exhibit 15: Intermediate international treasury organisation



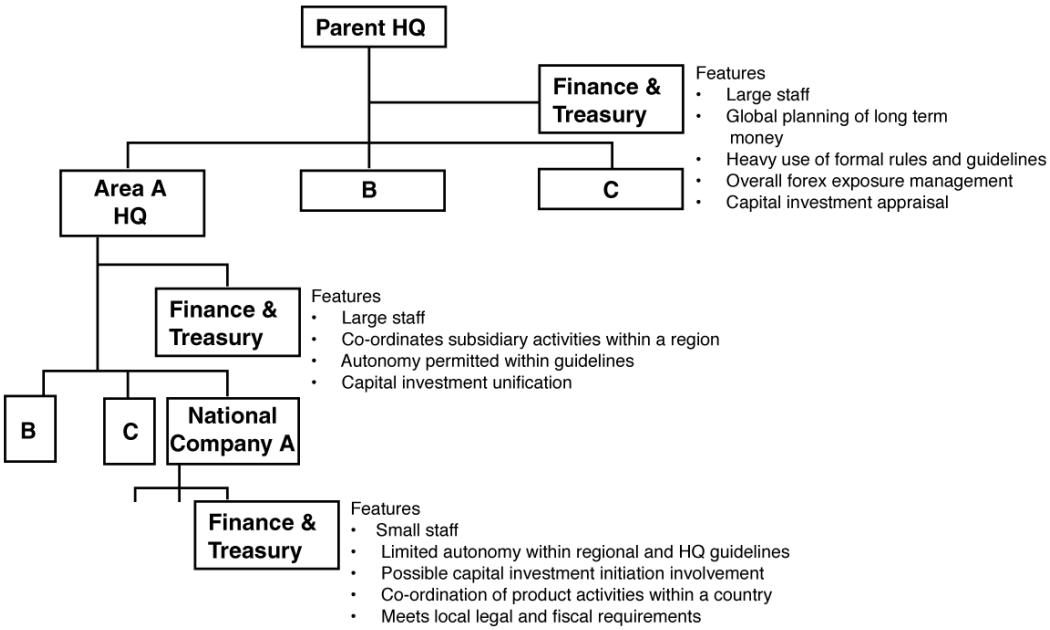
6.3 Advanced treasury organisation

Usually found with:

- High level of geographic and product diversity. High intercompany trading activity between overseas subsidiaries as well as with parent
- Controlled decentralisation within a well developed set of corporate rules.
- Found with matrix area based organisation structure. Finance function becomes more heavily tiered.
- Substantial international financial skills including specialist tax advice, treasury and controllership.

Characterised as “compromising with complexity”.

Exhibit 16: Advanced international treasury organisation



6.4 Non-wholly owned subsidiaries

The above discussion of structure assumed that the centre has a more or less free choice about which structure to pursue. This is not so easy where the operations are not owned 100%. Quoting Channon & Jalland again:

> ‘The presence of partnerships, joint ventures and other non-wholly-owned subsidiaries makes the implementation of centrally controlled financial management systems more difficult. This is especially true in politically sensitive investments, where managerial control may well be shared with governments or their agencies or where local participation is a prerequisite of investment. In some cases all possibility of complete financial control from the centre is lost, as in investments in associates. In these situations the management of a group capital structure alone is fraught with difficulties, as each subsidiary and associate tend to pursue independent policies. Further, distribution policies also become subject to greater risk and equity positions are threatened as individual companies use their own paper for raising cash, making acquisitions and the like. Most companies, therefore, endeavour to restrict their positions in uncontrollable finance situations. The wholly-owned majority activities may then be treated with a high level of central control, either directly or via detailed decision rules.

> The remaining minority of semi-independent local equity positions, joint ventures and the like are treated on an advise-and-consent basis only, although certain rights with regard to financial management will usually be sought at the outset of any such relationship.'

Subsidiaries engaged in significant levels of activity or investment requiring external funding may be pressed by lenders for local asset security or for guarantees/letters of comfort from parents. This is particularly likely in countries where the parent may be deliberately restricting its exposure by using joint ventures and third party funding. As a general rule, parents will not allow subsidiaries any discretion in granting security and will resist pressure to provide guarantees.