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Centralization of Treasury Management in a Globalized World

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Abstract

Centralization of treasury activities offers companies the ability to achieve higher efficiencies, greater transparency and access to real time information across a broad geographic area, multiple time zones, and many entities. There are different phases in the centralization of treasury management from the decentralized treasury towards fully centralized cash and treasury management. Many firms start with the centralization of foreign exchange and interest rate risk management as the first step towards centralization of treasury activities, and then proceed through cash and liquidity management up to fully centralized treasury.

The location of the treasury centre of an international grouping is a very strategic and hence important matter. The decision depends on numerous factors, such as the corporate tax treatment in the hands of the treasury centre itself, the applicable withholding tax rates and corresponding eligibility to foreign tax credits.

Keywords: Centralization of treasury management, payment factories, shared service centres, outsourcing, regional treasury centres
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1. Introduction

Treasury managers in many multinational corporations currently face huge challenges in managing transactions across multiple locations and time zones while working with many outside banks. The greater the geographic reach of a company, the more difficult it is to access and track accurate and timely cash flow information. At the same time, medium sized companies that are growing in market value and size must decide how to implement the right solution for managing an increasing volume of transactions. Centralization of treasury activities offers corporations the ability to achieve higher efficiency, greater transparency and access to real time information across a broad geographical area and many entities.

The first shared service centres were developed by American corporations at the end of the 1980s with the objective to maximize the return on investments in enterprise resource planning solutions. Today, multinational companies, especially those based in Europe and North America, are increasingly recognizing the benefits they can gain from centralizing their treasury and liquidity management. As a shared service centre combines multiple tasks, processes and IT infrastructures in one central location, one of the main advantages of the centralized treasury is the ability to deliver measurable, automated, unified, transparent, and efficient processes. Moreover, a centralized treasury pools highly qualified people, their skills and knowledge into one centre that allows management to monitor and grow treasury operations swiftly and efficiently.

2. The Degrees of Treasury Centralization

To decide about the appropriate degree of centralization/decentralization of the treasury activities and its timing, the following factors must be evaluated and considered:

- Volume of payments by amount and transactional volume.
- Nature of the payments (domestic, cross border, used currency).
- Type of payment – for example, paper and cash transactions are more effectively managed on a decentralized basis.
- Geographical spread – how many countries' systems and time-zones are involved?
- What is the company's structure?
- What controls are in place - a well established set of treasury controls is necessary to be in place to minimize the potential risks of centralizing treasury.
- Bank relationships – for example, in some countries of Southern and Central Europe, companies may be used to have banking relationships with more than one bank, and it may take some time for such companies to start to work with only one bank system on a global or pan-European basis.
- Treasury management system upgrade requirements and its integration with the ERP (i.e. Enterprise Resource Planning) system.
- In order to implement a successful centralized treasury, the company may want to relocate some key staff to a new the central location.
- And, there may be a concern of subsidiaries that, if funds are transferred to the treasury centre, they may not be returned as and when required.

To some degree, the process of centralization reflects the evolutionary nature of treasury management. It also reflects the differences in executing corporate finance and cash management activities. Developments in technology and the global financial markets have made it possible for funding and hedging requirements to be collected and executed centrally. Given the opportunities for cheaper and more effective management of these functions when handled centrally, most multinationals employ a professionally trained corporate staff to execute the transactions for the entire company and then to distribute internally the required funds or hedging.

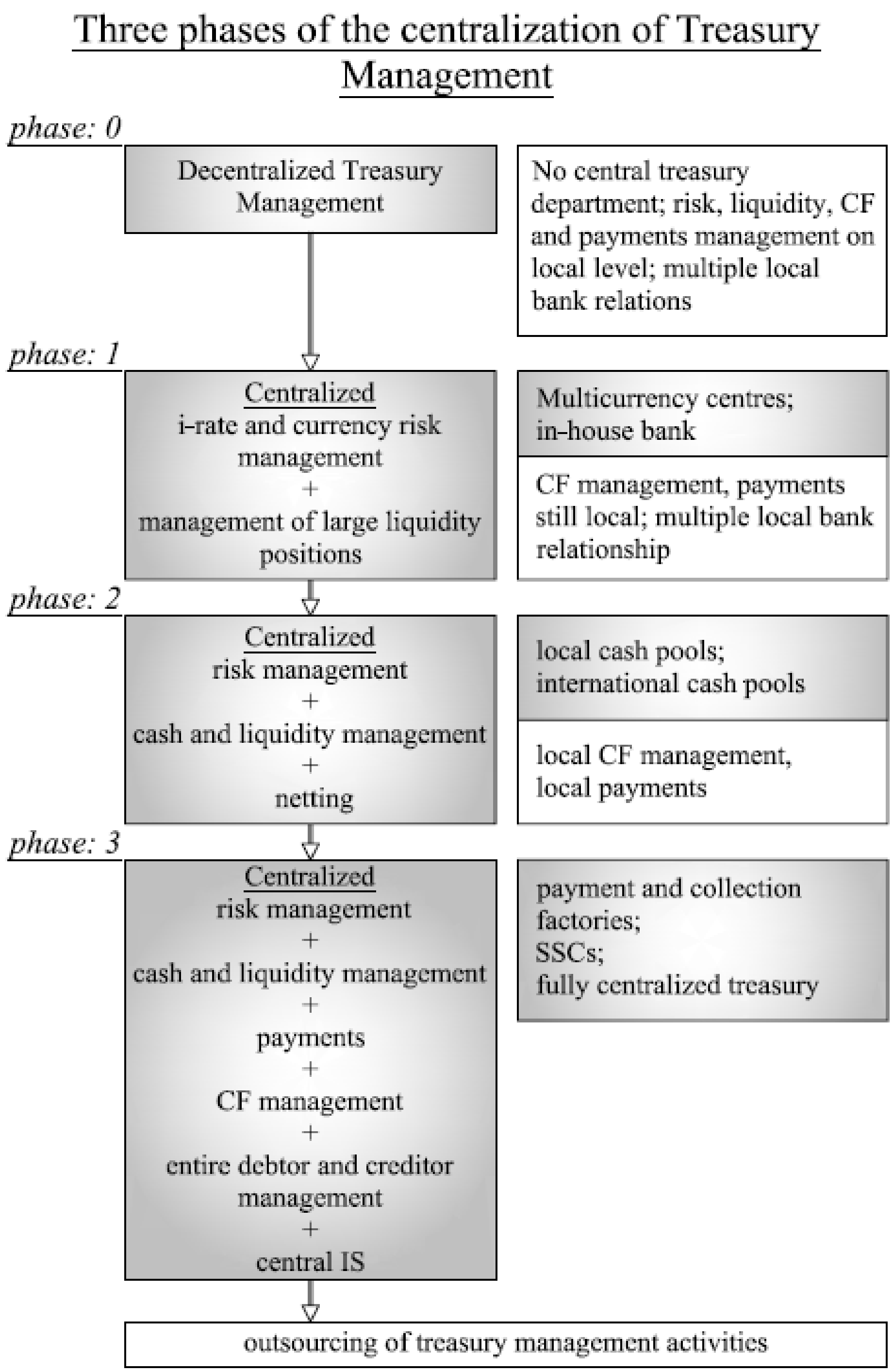
3. Centralized Treasury Management

Companies which have centralized their treasury activities have done so in various ways, depending on the culture and geographic spread of business activities. In some cases, companies will prefer a central treasury function in a single location from which all treasury activities are managed. In others, treasury may still operate as a single operation, but with locations in different parts of the world. These regional treasury centres may be responsible for regional cash management and also allow "round the clock" access to the financial markets. By using a single system, with the same database underlying it, the benefits of centralization can be achieved whilst still maintaining more local contact with business units and the local markets. Centralizing business support functions such as treasury is a vital way in which a company can equip itself to build economies of scale and rationalize costs, particularly when acquiring new businesses, therefore increasing return on equity. Every part of the business is continually challenged to demonstrate how it adds value to the rest of the organization and treasury is no exception. Centralization of treasury management is a key to achieving this by lowering the cost of debt, increasing investment return, providing expertise to business units, reducing financial risk and ensuring liquidity across the group.

In practice, we can distinguish three phases of the process of treasury centralization:

1. Centralized foreign exchange and interest rate risk management.
2. Centralized foreign exchange and interest rate risk management, plus cash and liquidity management.
3. Fully centralized treasury, including centralization of all incoming and outgoing payments.

Figure 1: Three phases of the treasury centralization



The first step towards the centralization of treasury is the creation of one central treasury department, that carries out a number of tasks (interest rate and foreign currency risk management) for the group. There are two typical types of central treasury departments: multicurrency centres and in-house banks.

The second phase is the centralization of cash and liquidity management by creation of domestic cash pools, cross-border and multicurrency cash pools and replacement of bank accounts at local domestic banks with accounts in the global (or pan-European) bank. The process is called cash concentration.

The third and final phase towards fully centralized treasury involves the centralization of transaction processing – that means, first of all, the centralization of all incoming and outgoing payments. In some cases, the documentary payments are also centralized. The centralization of transaction processing consists of the following steps:

- Centralization of all incoming and outgoing payments = payment factories.
- Centralization of the entire debtor and creditor management = shared service centres.

4. Corporate Treasury Outsourcing

Outsourcing is often seen as the next stage following centralization to achieve additional economic benefits. Many, especially medium sized companies, opt to outsource some part or majority of their treasury operations. Inside the treasury department itself, outsourcing of treasury management allows the corporate treasurers to concentrate on the strategic aspects of the job, leaving the operational issues completely to be taken over by the service providers.

5. Impact of a Globalization

As more companies expand operations across international borders, erratic behaviour of the international financial market necessitates standardization of international payments, as the simplification of fund movements becomes the extended challenge for corporate treasury. Corporate treasury is required to be more aware of the volatility of the international financial market and conversant with current payment standards practiced by other corporate treasuries, in order to keep up with international trends. For example, the recent implementation of the Single Euro Payments Area (SEPA) has resulted in replacing myriad payment instruments across the European Union countries by the SEPA credit transfer. The SEPA credit transfer was introduced in January 2008, and the SEPA direct debit in November 2009.

These challenges influence corporate treasury in determining the scope and coordination of centralized functions and the practicality of various organizational models. Despite the fact that some corporations have experimented with a single global treasury centre, most corporations have thus far preferred to consolidate to regional treasury centres, mostly because of language barriers and time zone issues.

5.1. Regional Treasury Centres: Structures and Models

Considering that most multinational companies have already decided to centralize their treasury and cash management activities, one of the most important questions is: “Where is an optimal location for our treasury activities?” If a new central treasury company is going to be formed to perform the international financing activities, the corporation needs to consider the optimum location from an organizational, as well as legal and tax point of view.

Giegerich et al. and the European Cash Management — a practical guide (2007) define a treasury centre as a ‘centralized treasury management function which is legally structured as a separated group or as a branch and is normally located in a tax efficient environment’. A ‘tax efficient environment’ is essentially a location that offers multinational companies a more beneficial tax regime compared with another location. Blair reaffirms the importance of the tax system. When Nokia needed to be closer to its international operation in Singapore, it considered setting up a regional treasury in Singapore, Hong Kong, Malaysia and Australia, but chose Singapore due to its more favourable tax regime. Furthermore, Murphy points out that RTCs[1] are primarily tax-driven, where tax on profits generated is at a favourable rate.

The functions of an RTC are fourfold: asset and liability management, sales and trading of currency, credit and derivatives products in capital markets, and financial risk management. Fundamentally, RTCs provide financial management and transaction services for the other group entities, that is, the subsidiaries located in different regions than the headquarters. The organization of treasury centres depends on the extent of treasury functions and management chosen by the treasurer. The treasurer may choose to manage practical treasury functions such as liquidity support only or simply direct the full range of functions to make treasury the main body of organizational process and hence, take on the full range of treasury services discussed by Potty et al. developed two base models to describe treasury management organization. In the first model, the treasury centre represents and operates all transactions for the group companies, while in the other model, it acts as the group's central in-house clearing bank. Mulligan describes treasury management organization as two extremes: centralized and decentralized. According to Mulligan, the performance of centralized and decentralized treasury management has a statistically significant difference, increasing the efficiency of RTCs. Murphy simplifies treasury centre organization structure as one US headquarters with one or more RTC under its control. Under this model, RTCs provide services under the group policy to the group entities located in their region. Treasury centre organization is structured according to the requirements of underlying business operations. Basically, the extent of functions and services of a treasury centre depends on the business operations.

5.2. Tax Environment for the RTCs

As mentioned previously, perhaps the most important factor when considering the location of an RTC is the tax environment. In this context, it is important to focus not just on taxes on profits, such as corporate tax, but also on the total tax contribution the company makes to the state. That includes:

- Withholding tax on interest, dividend and royalties.
- Corporate tax on profits allocated to the treasury centre and its capital.
- Thin capitalization rules.
- Stamp tax – the establishment of a new subsidiary may impose the stamp tax consequences.
- Value-added tax – in most countries, the VAT is not payable on certain financial transactions.
- Double tax treaty agreements.

The location of the treasury centre of an international grouping is a very strategic and hence important matter. The decision depends on numerous factors, such as the corporate tax treatment in the hands of the treasury centre itself, the applicable withholding tax rates and corresponding eligibility to foreign tax credits. Compliance with the transfer pricing rules and documentation requirements of all jurisdictions involved also needs to be considered, as does the appropriate management of thin capitalization rules to make sure a full interest corporate tax deduction in all jurisdictions is safeguarded.

The second consideration has to be whether any proposed central site will serve as a global or a regional centre. That having been decided, there are a number of major criteria.

- Political stability and legal environment. Are regulations and reporting requirements favourable?
- Geographical criteria, especially possibility of performing operations to all subsidiaries within the same (or close) time zones. This is the reason why companies with global operations often create the RTCs in three key time zones: Europe, America and Asia-Pacific.
- Availability of well educated and trained staff.

[1] RTC = regional treasury centre

- Liberalized financial markets and optimally important/existing treasury centre in the region.
- Easy access to important financial markets.
- Macroeconomic indicators, including prevailing corporate culture and development of the banking sector.
- Currency environment.
- Ratings – this measures the business climate and financial situation of a country in comparison to other countries.
- Highly developed infrastructure and communication network.

There are many factors to consider when searching a location for RTCs. For further reading, please see our papers (authors Polak, Petr and Roslan, Rady Roswanddy): "Location criteria for establishing treasury centres in South-East Asia" published in the *Journal of Corporate Treasury Management* and "Regional Treasury Centres in South East Asia - The Case of Brunei Darussalam" published in *Management – Journal of Contemporary Management Issues*, both published in 2009. These papers offer a full description of the location criteria that must be assessed before establishing an RTC. Both papers are available for downloading through the internet, e.g. at http://www.ssrn.com.

Wherever possible, RTCs are located in locations with friendly and tax-efficient business environments, especially if they include an in-house bank, and with highly developed infrastructure. In Europe, popular cities are London, Zurich, Dublin, Brussels, Amsterdam, Budapest, and Prague; in Asia-Pacific, Singapore, Shanghai, Mumbai, Hong Kong, and Sydney.

The criteria for locating new RTCs are changing continuously. Early RTCs were mostly located in high-cost countries of Western Europe, in the United States, or in Singapore, with their skilled workforce, high level of English proficiency, and highly developed infrastructure to support pooled financial service centres for corporates.

Today, while all these locations remain popular, many companies are looking at regions such as the European Union members of the Central European region (the Czech Republic, Hungary, etc.), where the cost structure is still relatively favourable, language skills and education levels are high, and tax incentives exist. Often these can be linked to production sites that companies have already set up in those countries.

In Asia at the moment, many companies are choosing to locate their treasury centres in low-cost bases on the Indian subcontinent, in China and the Philippines. China and India are also providing important locations from both cost and strategy perspectives. The English language hubs in Asia, such as Singapore and Hong Kong, continue to be popular. Although they do not have the cheapest cost base, they have the necessary infrastructure and skills to support pooled financial service centres for corporations. Some companies are also splitting larger treasury centres across several locations, with a regional centre in Singapore or Hong Kong and distributed operations in low-cost places such as Shanghai or Manila.

To compete with existing centres in attracting RTCs, state administrations must remain vigilant about regulations applicable to overseas investors. Sometimes they may have to make changes to improve the current environment. They must examine current tax regulations imposed on both local and international companies. For example, at the end of the 1990s Nokia chose Singapore for its RTC because of unattractive tax regimes in Hong Kong, Malaysia and Australia, which it considered and rejected. In fact, by improving its tax environment, Singapore has attracted more than 4,000 regional headquarters from just 49 in 1993. Since local tax regulation is the primary factor when considering a location for an RTC, other jurisdictions would do well to regulate their tax systems as competitively as Singapore and Hong Kong, which have enjoyed great success in attracting RTCs.

An effectively functioning banking system is another key factor in attracting RTCs. That means, a pressure on the effective functioning of the banking system as good and modern banking sector and a presence of a competitive, level playing field for all banking institutions, domestic and foreign, are the key factors to attract RTCs. As well as financial markets require a suitable regulatory, legal and judicial framework that establishes, with the highest degree of certainty possible, the rights and obligations of parties to financial transactions and provides appropriate disclosure and other requirements.

And, finally, by increasing the number of students majoring in finance at tertiary level educational institutions, countries can attract multinational companies and their RTCs, which require trained specialists in the finance area and will be attracted to regions with an abundance of treasury related expertise.

5.3. Nearshoring

To cite Eric Mueller from Deutsche Bank, many corporations are taking a new approach that has become known as “nearshoring” (instead of previous “offshoring” to low-cost countries such as e.g. India). For European based companies the term “nearshoring” generally refers to the establishment of shared service centres in Central European countries (mostly Hungary and the Czech Republic, both countries with no legal restrictions to cash concentration and/or notional pooling) where “skills are high, cultural and language barriers are less pronounced, and costs are still relatively low.” And, indeed, for many such corporations, a location in these countries often comes with the benefit of being closer to existing manufacturing facilities.

6. Conclusion

Centralization of treasury activities offers companies the ability to achieve higher efficiencies, greater transparency and access to real time information across a broad geographic area, multiple time zones, and many entities. There are different phases in the centralization of treasury management from the decentralized treasury towards fully centralized cash and treasury management. Many firms start with the centralization of foreign exchange and interest rate risk management as the first step towards centralization of treasury activities, and then proceed through cash and liquidity management up to fully centralized treasury.

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