ASSOCIATION FOR FINANCIAL PROFESSIONALS

In-House Banking: Is it Right for Your Treasury Function?

Treasury in Practice Series

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ASSOCIATION FOR FINANCIAL PROFESSIONALS

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Treasury in Practice Series

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Dear AFP members and guests:

The last decade has seen global organizations strive to cut costs and maximize profitability, but with an emphasis on sustainable growth. Despite the fact that world trade has grown tenfold in 30 years, the fragility of the markets is tested constantly with risks that surface with increasing frequency and vigor. Recent years have also seen rapid globalization and expansion, a rise in geopolitical and economic uncertainty, increased FX volatility and the world becoming more interconnected.

At the same time, new regulatory reforms are also being introduced increasingly based on dialogue with the regulated and in coordination across regulators to minimize unintended consequences of regulations. As a result, many companies are forced to reconsider a more effective approach to managing FX risk and funding. The use of in-house banks to improve visibility and control is one option companies strongly consider, but is it right for every treasury function?

In an effort to help treasurers and their teams better understand and equip themselves in the face of ongoing volatility in FX markets and changing regulation, Thomson Reuters has underwritten *In-House Banking: Is it Right for Your Treasury Function,* the latest installment in the AFP Treasury in Practice series. This piece takes a back office look at in-house banking, providing a glimpse into what multinational corporate treasury teams do on a daily basis to manage their cash and FX needs around the globe.

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In the past decade, many multinational corporations have turned to in-house banking solutions for global cash management, and it's easy to see why. Treasury departments understand that their subsidiaries need funding, and they are looking for a more cost effective way of doing that than having each unit borrow from a bank locally. In-house banking provides a way around that, as well as a good solution for cash visibility and managing FX.

This *Treasury in Practice* guide is intended to be a back office look at in-house banking, providing a glimpse into what multinational corporate treasury teams do on a daily basis to manage their cash and FX needs around the globe. Perhaps after hearing from some of your peers on their in-house banking procedures, you'll have a better idea of whether this solution is right for your treasury team.

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How in-house banking works

"An in-house bank can be many things—at one end of the scale, a bank that every subsidiary has to deal with for every transaction, or at the other, an attempt to improve visibility of global cash, exposures and treasury activity while still leaving some autonomy with local entities for local arrangements," said Miranda Hall, director, international treasury services at Thomson Reuters.

As noted by Manuel Martinez, senior manager of treasury services for The Rockefeller Group, there are five key benefits an in-house bank offers treasury departments.

- **Centralization of control:** An in-house bank allows treasury to control all of its subsidiaries' accounts in one place.
- **Concentration of funds:** Through ADT (auto dollar transfer) and ZBA (zero balance account) features, an in-house bank uses a concentration account to accumulate and distribute funds to all business units.
- **Less reliance on external funding and investment instruments:** An in-house bank reduces the need for business units to obtain external loans, credit facilities, investment instruments, bonds, commercial paper, etc.
- **Creation of lender and borrower rates:** An in-house bank provides treasury with a way to determine company specific lender and borrower rates and terms.
- **Cash visibility:** Perhaps most importantly, an in-house bank provides treasury with a better means of keeping track of cash and balances.

Rockefeller's in-house bank operates a concentration account that collects from the New York-based real estate company's 85 attached business unit accounts through ADT. Every day, there are inflows and outflows that occur through each of the various business units.

A key reason many treasury departments use in-house banking is because they need a better way to track where their funds are going. When Rockefeller first implemented its in-house bank, it adopted Kyriba's mapping rules and batch modification processes which provide visibility of inflows and outflows. "We can look at specific codes and specific account numbers and say, a business unit sends out $1 million, then we can keep track of that $1 million going out," Martinez said.

Using that example, let's say Business Unit A makes a $1 million payment and is funded $1 million by the in-house bank. Just like a traditional bank, the in-house bank charges a borrowing cost to subsidiaries that borrow, Martinez added. In the case of Business Unit A, for every day it has a negative balance, it is charged Rockefeller's AA nonfinancial CP 30-day borrower rate, and an additional 1 percent. "So what we're trying to replicate in our in-house bank world is, if you are a borrower, you're going to get charged a higher interest rate than if you are a lender," he said.

Continuing with the same example, on the same day, Business Unit B receives a $5 million payment from a customer. It moves that money into the in-house bank by the end of the day and is charged a "lender" rate that translates to interest income.

"The concentration account would have sent $1 million to Business Unit A to bring it back to zero, and would have swept $5 million in from Business Unit B to bring that account back to zero," Martinez said. "If the concentration account had an opening balance of $10 million, the net effect would be $4 million in on that particular day and the ending balance would be $14 million."

Rockefeller's treasury group doesn't have to keep track of all of this manually; it uses Kyriba's treasury workstation. Martinez and his team have a bank feed that lets them know that transactions have occurred. Kyriba's mapping rules provide codes that advise treasury on what to do in certain circumstances. Again, using the example above, Business Unit A has a $1 million balance and would have a code of -1MM because it paid out money. In contrast, Business Unit B would have a code of +5MM.

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In this scenario, Business Unit B is adding to the pool, or concentration amount that enables Rockefeller to maintain and run its in-house bank. By tying all of the business units to one concentration account, none of the company's 85 business units need to get their own loans or investment instruments.

Major undertaking

Obviously, making the move to an in-house bank is a huge undertaking. While there are clear benefits to doing so, treasury departments need to build a business case for it. Robert Waddell, assistant treasurer for Brown-Forman, who is slotted to speak about his company's upcoming in-house banking implementation at the 2016 AFP Annual Conference in Orlando, knows that can be an arduous process. His treasury team had everything in place, and then it all got snatched away.

"We had gone through a multi-year planning process," Waddell said. "We'd done a lot of work with Bank of America Merrill Lynch, and we had approval from our CFO. We'd gone through budgeting and aligning the team—and then our CFO left. So we had to stop. And we've had some other things going on—some restructuring and so forth. But once we had a new CFO come in, they asked us to revisit it."

Like most multinationals, Brown-Forman, one of the largest U.S. companies in the wine and spirits industry, produces a lot of cash—hence the reason why an in-house bank would help immensely. "We have excess cash in pockets," Waddell explained. "We have a global ERP system, we have visibility to our cash, we just don't have a mechanism to automatically pool it. We do it somewhat manually; we use our own cash to fund entities that need funding, and that's provided by entities that have excess cash."

Brown-Forman already operates much like an in-house bank, which is more economically than for the company's subsidiaries to obtain external loans locally. "It's better to use your own cash, and also to have cash quickly available for M&A activity," Waddell said.

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When the first Grexit scare happened several years ago, that was when Brown-Forman first began to consider in-house banking. "When Greece was looking to leave the EU and we saw the contagion that could happen as a result of that in other markets that are larger for us—that made us think more about in-house banking versus having the banks collect money locally, and trying to manually pool cash," Waddell said. "The idea was, if our Greek and French entities had bank accounts in the in-house bank and all of our customers know to pay that in-house bank, there is no sovereign risk because the money leaves there from our customer's hands and goes to our bank account—in the Netherlands in this case, our treasury center—it's protected."

Brown-Forman's concerns about contagion have only been exacerbated by the recent Brexit vote. "It sort of helps support the need for [an-in-house bank]," he said.

Key advantages

Logistics giant DHL Americas uses in-house banking to sweep its cash out of the United States to its German parent company. DHL has a multitude of subsidiaries in the U.S., and each one is treated as a separate entity, explained Bob Whitaker, CTP, senior vice president, corporate finance for DHL Americas and a member of AFP's Board of Directors. Each subsidiary has its own separate external bank account(s), and all bank accounts are ZBA structured into DHL's parent's master account in the U.S.

"Every single day, the subsidiaries' balances in their disbursement or collection accounts are zero," Whitaker said. "All the cash concentrates into the parent's bank account. Those inflows or outflows to the specific subs are the entries that go into the in-house bank account. Ultimately, that's for scorekeeping—whether the subsidiary has deposited cash with the parent in the in-house bank, or if it borrowed money from the parent in the in-house bank. And then the net cash gets swept to Europe every day."

DHL also uses its in-house bank for intercompany clearing. Rather than sending money to the 220-plus countries in which it operates, DHL clears intercompany invoices via debiting the in-house bank of the paying party.

In-house banking also allows companies like DHL to cut out a lot of expenses. For example, DHL's freight forwarding division, which ships intermodal containers, operates in more than 150 countries. If a DHL location in China sends a container to the United States, it needs to pay its counterpart to unload it and deliver it to its customer's warehouse. "We have to pay each other back and forth, and in the old days, the way that was done was, they reconciled their invoices and then they wired money back and forth among 150 different countries," Whitaker said. "If you can just clear in an internal system and scorekeep in an in-house bank, the first thing you save is all the wiring and transaction fees for moving money around the world."

Additionally, in-house banking provides a way for parent companies to manage FX exposures for their subsidiaries. DHL's in-house bank does this on a regular basis.

"For example, I'm in the U.S. and I have a large Canadian dollar receivable," Whitaker explained. "I will hedge that position with the in-house bank and end up with no exposure on my

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side, and that centralizes the exposure to the parent. The parent just accumulates all of the exposures around the world in that currency. Whatever the net exposure for the group is gets hedged externally. It's a very efficient, cheap way for hedging your exposure away for your subsidiaries. " Having a tool for hedging has afforded companies like DHL some stability amid the current volatility in the FX markets, which again, has intensified in recent months due to the Brexit vote.

However, according to Ron Leven, head of FX pre-trade and economic strategy at Thomson Reuters, FX volatility among major currencies is actually below multi-decade averages overall. "This is particularly evident in the historic percentiles for implied volatility and curve steepness shown in Thomson Reuters Currency Value Tracker," he said. "Given this seeming divergence between potential significant event risks and the low cost of volatility, it would be prudent for corporate treasurers to be relatively aggressive toward hedging currency risks."

When hedging FX risk, the reliability of cash flow and exposure forecasts is a key concern for treasurers. Forecasting exchange rates is incredibly difficult; former Federal Reserve Chairman Alan Greenspan once compared the practice to flipping a coin. Additionally, there is a high propensity for bias. "Given the difficulty of forecasting and the danger of bias, it is important that treasurers have an external source to benchmark their views," Leven said. "It is also critical to have a reliable source of macroeconomic and political information to be alert to changes in the underlying assumptions of the forecast."

Thomson Reuters's in-house bank funds and defunds its legal entities' accounts, completing intercompany loans in the most appropriate currency for each entity. "We have hundreds of legal entities, and many more bank accounts in 40 to 50 currencies," Hall said. "Wherever possible, we're centralizing those currencies back to treasury entities, either in London or in the U.S. and occasionally in Asia."

Though headquartered in Canada, Thomson Reuters is a USD functional company and reports in U.S. dollars. "Almost all other currencies are bought and sold on a daily basis," Hall said. "Generally, if we're short a currency, we'll buy it against dollars to cover that overdraft. If we're long a currency, we'll sell that currency and buy dollars so that we've got dollars to either invest or pay down our short-term debt. That all happens in London because that's the easiest place to do it; we can have multiple currency accounts in the treasury entities here, in the in-house bank. We'll be spot daily trading on those."

Thomson Reuters doesn't perform a huge number of these deals; there are typically between five and 10 deals per day totaling $4 to $5 billion per year. Nearly all are handled by treasury through the in-house bank. "We try not to let anyone deal locally unless they are other treasury people; we have someone in Singapore and we have one in Buenos Aires and they handle Southeast Asian and LatAm deals. But generally it's all handled in the here," Hall said.

Regulatory repercussions?

One thing that could have a massive impact on in-house banking for corporate treasurers is the Treasury Department's proposed changes to section 385 of the Internal Revenue Code. While the changes are intended to target cash inversions, they would inadvertently disrupt cash pooling for many companies.

Although there have been rumblings lately that a carve-out for cash pooling may be in the works at Treasury, there is still a chance that will the rules will go into effect unchanged. If that happens, in-house banking is in for a massive shakeup, warned Bob Stark, vice president, strategy for Kyriba and a speaker at the 2016 AFP Annual Conference. "I hope that carve-out happens," Stark said. "But in-house banking, by nature is open-ended; there's no structure to it really unless it's documented in a way that suggests there's a repayment date."

It's these open-ended liquidity tools that have gotten Treasury and the IRS so concerned, Stark continued. "Whether it's in-house banking or even intercompany loans that have no defined maturity—those are under the radar screen," he said "If it's basically a one-sided transaction—there's just a one-way flow—then they think that could be just a repatriation of cash and you're using intercompany loans to mask that."

In the case of in-house banking, a corporate could just keep "lending" to the bank and be charged interest. And if the corporate is investing in the bank, then it is receiving interest back. "But there's no expectation of repayment," Stark said. "It's not necessarily a loan; it's more of an investment from that standpoint. And that's where it crosses that line."

The movement of much of that cash is well-documented at many organizations. For example, companies that use multilateral netting programs use e-invoices for documentation. "The net amount, per currency, per entity, can be physically settled or sent as an in-house bank transaction," Stark said. "And if there is a carve-out, those transactions will probably be okay because they invoice to document the actual movement of cash. It's the ones that are undocumented—those are the ones that are going to have issues if there is any sort of impact on treasury."

It's not uncommon for a corporate to specifically use in-house banking for undocumented transactions, Stark explained. "I'm sweeping out cash from here to here. You basically have a physical cash pool, and you're concentrating funds, and those funds happen to exist in accounts owned by different entities," he said. "What the IRS is concerned about is those that are foreign, but the

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same thing happens for ones that cross domestic business units—there's this concept of taking cash from somewhere else and there's a tax impact if you're moving it from entities. Because effectively, you have a liability on the books on one side and an asset on the books on the other side. And the IRS wants to sniff around that and make sure it's not one-way travel.

Stark added that quite a lot of companies that use in-house banking do not have adequate documentation. "Some organizations literally see it as a way to facilitate cash mobility—and maybe there, there's not much documentation outside of the fact that there's a structured interest rate that's either paid or received based on whether it's a negative or positive balance in the pool," he said. "You'll see statements that document the relationship, but it's not necessarily the loan itself that's being documented—and those are the ones that are going to have problems."

So moving forward, if Treasury's proposed regulations pass, those organizations will have to begin documenting everything. Because ultimately, unless the rules are struck down completely—and there is a zero percent chance of that happening—companies still have a lot of work ahead. "Every organization is going to have to bring in their auditors or potentially their advisory folks to look at all of their intercompany loans," Stark said. "They're going to have to look at every single one to determine if there's documentation in place and whether there is a potential reclassification to equity as defined by section 385. Even if they did everything right and there is no reclassification, it's still a lot of work and a lot of billable time. That's going to happen anyway."

But even if a cash pooling carve-out is imminent, there's a possibility that in-house banking may no longer be practical for some organizations going forward. "The whole idea behind an in-house bank is that you sweep the cash and then you compensate the subsidiary for the cash you took from them," Stark said. "And that exercise, by nature, doesn't have an expectation of repayment. So there could be in-house banking transactions that instead have to be classified as intercompany loans and they'll probably run different than they are today."

Conclusion

In-house banking clearly offers a variety of benefits for multinational corporate treasury departments such as better control and visibility over cash, less reliance on external funding and better management of FX exposures. However, implementation is an expensive and lengthy process that will require treasury to build a business case if it wants to convince senior management of the need for it. Furthermore, with regulations looming that could force companies to eschew cash pooling and by extension in-house banking, building a business case for implementation may prove even more difficult for many treasury departments.

Is An In-House Bank Right for Your Treasury Function?

There are many reasons to adopt an in-house bank. But is it appropriate for your treasury department? It allows treasury to:

- Control all of its subsidiaries' accounts and FX exposures in one place
- Use a concentration account to accumulate and distribute funds to all business units
- Rely less on external funding and investment instruments
- Determine company specific lender and borrower rates and terms.
- Keep track of cash and balances.

Nevertheless, a lot of pieces have to fall into place for an in-house bank to work. If treasury is planning to implement one, it's a good idea to keep a few factors in mind.

- Moving to an in-house bank is a huge undertaking; treasury will need to build a strong business case to gain support from upper management.
- The bank account structure of the organization will need to be aligned to allow funds to move between subsidiaries and the parent.
- Given the implications of the Treasury Department's proposed changes to section 385 of the Internal Revenue Code, Treasury may need to document the movement of cash to show that it's not all a one-way flow.

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About the Author

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