Citi Services | Client Advisory Group

In-house Banks: *As relevant as ever in today's world*

Lessons learned from top performing companies and the impact of real-time treasury

In-house Banks (IHBs) may not be a riveting topic. Yet, they remain a linchpin of top performing corporate treasuries.

For those less familiar with IHBs, they are a concept comprised of a legal entity, liquidity structure, system infrastructure, and personnel. The IHB serves as an internal virtual bank, designed to centralize cash, investments, foreign exchange (FX) currency exposures, intercompany lending, and transacts on behalf of participants.

An IHB has the ability to reduce overall banking transactions. It is important to recognize that an IHB is not a regional treasury center, shared service center, re-invoicing center, or cash pool. Although, it may be supported by – or support – all of the aforementioned.

Look under the hood: Build a fuel-efficient liquidity engine

The IHB centralizes liquidity by moving cash across the organization through a physical cash concentration structure. This structure is underpinned by intercompany agreements that formalize the lending and borrowing positions between itself and participating entities. The same liquidity structure is the engine that drives loans to affiliated entities in need of cash.

The centralization drives more efficient use of cash and less need for working capital.

Time out for some minutia. It is important to point out that a multi-entity notional pool cannot support IHBs due to the absence of intercompany loans. Some firms add an optional layer of a single-entity notional pool to their physical cash pools at the cash pool header level for greater mileage in managing long and short cash balances across currencies. This can reduce the incidences of overdrafts where cash forecasting falls short.

Most successful IHB implementations follow an incremental approach starting with physical cash concentration and expanding the suite of services over time.

Here are some additional fine points to know. Beyond basic cash pooling functionality, IHBs can turbocharge cashless settlement of intercompany accounts receivable and payable, where regulations allow. This is done through a series of accounting entries, which is made possible by the required intercompany agreements. For third party payments, Payments on Behalf of (POBO) and Receivables on Behalf of (ROBO) structures are often added as an additional service the IHB provides. The benefits of POBO and ROBO include reduced bank accounts and lesser cash movements to subsidiaries. Citi Treasury Diagnostics (CTD)[1] found that 64% of companies with IHBs have some form of intercompany cashless netting, while 33% have POBO structures and 11% have ROBO structures.

Most successful IHB implementations follow an incremental approach starting with physical cash concentration and expanding the suite of services over time. As new technologies and banking solutions emerge, and organizations develop the expertise in-house, these initiatives achieve improved efficiency and incremental benefits.

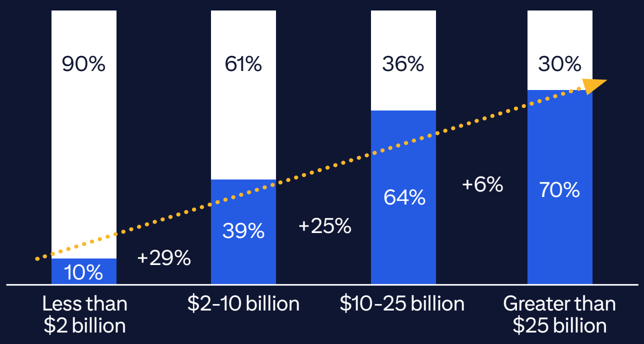
Play the long game: Reap big benefits down the winding road

Here are some practical suggestions to keep in mind. Avoid focusing narrowly on implementation costs at the outset, as larger cost savings and benefits will accrue over time that justify the initial expenditures and effort. Once fully embedded into the entire organization, an IHB offers considerable advantages by facilitating the rationalization of bank accounts and relationships. They can also improve investment returns, reduce debt, idle cash, and bank overdraft incidences, thereby leading to lower overall bank fees and finance costs.

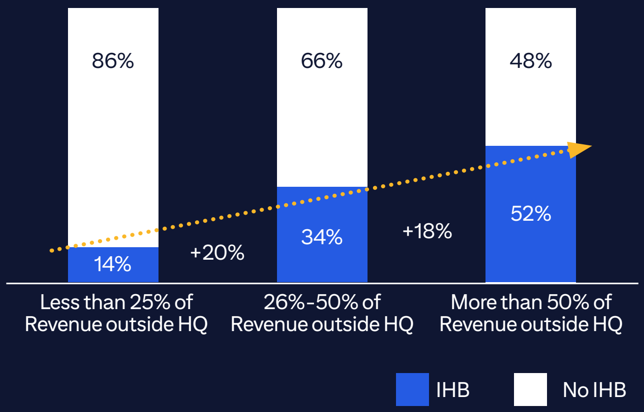
A structured intercompany loan process can enable greater usage of less costly intercompany loans and reduce reliance on more expensive equity capital, to achieve a more efficient capital structure that enables treasury to better support a company's growth. Leveraging standardized, automated processes and control structures allow the business to run on less operating cash. IHBs also support more accurate cash forecasting with greater cash visibility and can make the settlement of intercompany transactions cashless. They also can have the advantage of centralizing FX risks to a single legal entity and neutralizing currency exposures elsewhere. This helps make FX risk management more effective and allows for a more efficient portfolio approach to hedging.

This centralization and automation help lead to better corporate governance, greater tax transparency, and policy compliance.

Company Size / Revenue[1]



Globality / Geographical Presence[1]



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[1]Source: Citi Treasury Diagnostics

IHB | Key Considerations

Incorporation

- Based on tax and legal considerations, where is the most optimal place to incorporate the legal entity for the IHB?

Liquidity

- Where will the liquidity structures be placed?

People

- Where will the people who run the IHB sit?
- How will it be managed regionally / centrally?

Systems & Services

- What services does it support?
- What systems will be used?

Strike while the iron is hot: Seize the opportunity when still small

So, many of you may be asking yourselves if an IHB makes sense for your business, particularly if your company is not a large multi-national.

In determining when to implement an IHB, the company size matters as it often equates to the degree of commercial complexity. Using global sales as a proxy for company size, Citi[1] finds 67% of companies with more than $10 billion in sales have IHBs. Given the indisputable benefits, and as treasury technology becomes easier to deploy, many companies are now starting the path to an IHB at an earlier stage.

Global presence matters. Managing multiple currencies and regional regulations add greater complexity and risk to liquidity management that are mitigated via centralization. Citi[1] found that 52% of businesses with more than half of their revenue collected outside of their headquartered country benefit from IHBs, which does not suggest waiting until your company becomes very global.

While statistics imply that the benefits accrue to large firms, we believe the real winners are smaller firms. These savvy companies seize the opportunity early. They start the justification, planning, and implementation phases before they become too complex and too global. The bigger you are, the bigger the lift. You want a small lift and build incrementally.

Take a deep dive: Understand the critical success factors

Let's take a closer look at what it takes to achieve IHB success. An effective IHB deployment boils down to four factors – domicile of legal entity, people, liquidity, and technology. Companies need to determine the most optimal location to incorporate the legal entity based on tax and legal considerations. Let's not forget staffing where the management of the IHB will happen. The level of sophistication and skill required to effectively operate an IHB may necessitate a different skillset. This investment to train personnel should pay dividends down the road.

Another key consideration is, of course, liquidity. Treasurers need to determine where the liquidity structures will be established to meet the intersection of business needs, people, and services the IHB will offer. The location of the cash pooling bank accounts does not need to be the same as the IHB legal entity incorporation. Ideally, the location of the bank accounts will be where your cash pooling banks' capabilities are at their best. Lastly, selecting the right technology service and systems to support the IHB deployment is essential, whether you choose a TMS or native ERP solution, or build your own. The technology solution should include accounting of cash movements, intercompany lending, netting of intercompany accounts payable and receivable, POBO and ROBO transactions, and integration with your back-end accounting systems.

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Beyond these considerations, there is also a need to achieve organizational alignment, and build a business case for technology and resource investments. Obtaining broad organizational buy-in and senior management sponsorship will be crucial to move forward.

Once the decision is made, effective project management and resource allocation will be essential. This cannot be a part-time job; it requires full-time commitment. The process should include clearly defined responsibilities for the treasury team, as well as thoroughly documented operating procedures. Treasury policies should be codified, and existing policies should be reviewed to weigh any new circumstances brought about by the implementation. It is also pertinent to centralize and standardize intercompany loan agreements and processes to ensure success.

Address the elephant in the room: Discuss the implications of Real-time Treasury

The fast-emerging trend towards real-time treasury (RTT) must be considered. Simply put, "real-time treasury is the evolution of banking, liquidity, technology, and payment systems that operate in continuous motion," according to Citi's Real-time Treasury article[2]. RTT may not be consumable in today's in-house banking technology structure. Therefore, you must think about where RTT will be in five years vs. where it is now, and account for that in your planning.

There are three enablers to RTT: data, applications, and connectivity. The ability to exchange near real-time data almost seamlessly between banks and companies through Application Programming Interfaces (APIs) is key to real-time automation that may lead to process improvements in bank account reconciliation, bank balance reporting, and user experience. The real-time connectivity made possible by APIs provides a gateway into another level of treasury management. This enables greater awareness and insight and may help to mitigate financial risks while allowing teams to capitalize on opportunities to better manage liquidity across the business.

While RTT innovations hold the potential to increase the efficiency and effectiveness of IHBs, it may present some control and process challenges.

Today, the core cash management tool underlying IHBs is a physical cash concentration structure. Typically, using a global cash concentration bank, IHB bank accounts at a central pooling center are connected via sweeps with subsidiary bank accounts around the world. Subsidiaries can make payments during the day supported by Daylight Overdraft Lines (DOLs) from the concentration bank. At the end of each business day, automated, cross-border bank sweeps centralize cash into IHB bank accounts at the pooling center, while subsidiaries end up with zero balances.

Shifting to real-time – where outflows may occur outside traditional work hours – may mean revisiting all these. There would be a need for beefed up liquidity buffers or higher DOLS at the subsidiary local account level (at least, so long as the market does not move towards charging interest on overdrafts over the weekend). The alternative would be a bank that can sweep on a 24x7 basis.

Centralizing all currencies into one location – today's predominant model – may not be optimal, since liquidity is best in the currency center. The better alternative may be to have an account structure whereby the location for any USD is New York, for any AUD it is Sydney, and everything in-between. Through the IHB, subsidiary payments, and their customer collections, are made through these currency center accounts.

As such, new treasury functionalities and policies may be required to adapt to this new paradigm. No one ever said advancements would be an effortless piece-of-cake.

Treasurers may also need to rethink their cash forecasting process. Around-the-clock payments and cash movements may present potential surprises that require new strategies to address cash forecasting accuracy. As the velocity of disbursements and payments increase, cash likely need to be treated like inventory, where claims on cash available can be made. And if unclaimed cash is not available, payments and disbursements may need to be systematically throttled. Ultimately, systems and technology need to keep up to operate 24x7x365.

[2]Source: Real-Time Treasury: A Response to Four Fluid Forces

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Keep your eye on the ball: Build a robust and resilient Treasury

IHBs may not be the newest or shiniest tool in treasury's toolkit, but they remain the centerpiece of the highest performing treasuries. Three key considerations to successful deployments are:

1. **Do it right:** Invest the time and effort to build the IHB correctly – put the foundational elements in place, consider the big picture, think long-term, and explore implementing before complexities grow. Avoid short-cuts.
2. **Find the right provider:** Look for a bank that understands how these structures function and operate – one that takes an advisory approach with a collaboration perspective and has the experience to help companies reach their fullest potential.
3. **Prepare for RTT:** Real-time innovation is not a fad. Blockchain, APIs, and tokenized services, just to list a few, are here to stay, which means treasurers need to consider how they will impact treasury.

The IHB is arguably the North Star to top performing, resilient treasuries. The biggest question is how new banking technologies and innovations that constantly change will impact how they operate.

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