The move toward centralization

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Part 2 in a thought leadership series providing insights into the trends that are impacting treasury.

Treasurers influence broadens

A migration from decentralized to centralized treasury and working capital structures is a mature trend resulting from changes in the business environment over the past decade.

The rapid pace of mergers and acquisitions (M&A), new technologies, international growth and regulatory changes – much of this stemming from the financial crisis of 2008 – is requiring organizations to be more efficient and streamlined.

Against this backdrop of continuous change, the constant drivers in a treasury function remain: control, compliance, risk management, cost efficiency and working capital optimization. The challenge is correlating this to a need for global 24/7 operation. Centralization is key.

Centralization in healthcare

Centralization is a broad term, and its definition may vary across different companies or industries. A company's business, its operating model and its strategic objectives may have an impact on the level of centralization that treasury can achieve. One excellent example of this is in the healthcare space. After numerous years of heavy M&A activity and regulatory change within the healthcare industry, hospital systems are driving efficiencies by leveraging technology to centralize and enhance revenue cycle operations. Many systems are migrating to state-of-the-art patient accounting systems to enhance capabilities, automate processes and improve future integration effectiveness. This centralization trend is finally allowing the industry to improve efficiencies and reduce administrative costs to meet the demands of the future of healthcare.

Why centralize?

- Cost efficiencies
- Standardization
- Enhanced controls

Impact on the role of treasury

The buildup of complexity in the business environment has caused companies to take a step back and look for ways to gain new efficiencies and position for future growth. In particular, many companies are asking their treasurers and treasury operations teams to work closely with their businesses to enable more efficient use of global and regional cash flows, consolidate business functions through technology innovations and drive cost savings by improving and standardizing processes.

An optimized, centralized treasury structure that concentrates knowledge, processes and operations can move the treasury function from process execution to oversight and control. More importantly, this type of centralization can enable treasury to become more strategic in how it supports the company's longer-term goals.

The trend in treasury consulting for many years has been to optimize process steps. This is no longer the source of highest return. While efficiently executing the steps of your liquidity processes is still important, the focus has shifted to key performance indicators (KPI). These KPIs are a better indicator of overall value and enable the use of structures for functional solutions, such as on-behalf-of models, virtual accounts, constant currencies and more. This allows treasury to remotely control its dispersed operations across the globe in real-time, and to move from decentralized (operations and controls) to centralized (automation and oversight).

Treasury model impacts

Several treasury structures have emerged to support centralization in an organization, such as shared service centers, in-house banks, on-behalf-of structures, and intercompany/netting. The structures vary in function, however each provides a means to unlock the value of centralization whether through more standardized processes, consolidated IT platforms or bank account rationalization. This level of centralization helps companies develop the operational capability to remain agile as they continue to grow.

> *"Centralization can raise the role of the corporate treasury to a strategic influencer to the business."*

Centralization is often a first step of companies seeking to automate because it encourages standard processes. With greater automation and fewer manual processes come lower costs and fewer transactions. By rationalizing bank account structures and services, organizations benefit from less operational redundancy and the ability to leverage scale to enhance negotiating strength with banks and vendors.

Standardizing core processes across global operations – which is often needed when processes and systems have accumulated due to M&A or international growth – can also greatly improve controls and compliance. This offers more centralized oversight and exception management. Consistent policies and procedures result in better visibility and reporting.

Working capital optimization can be further achieved by leveraging enhanced technology, simplifying liquidity structures, providing more accurate cash flow forecasting and boosting FX oversight and controls. As companies grow and change, greater productivity and scalability are possible.

It's important to note that centralization comes in many shapes, and no one solution fits all businesses or functions. In some instances, a decentralized model may be more suitable, based on local regulations or client requirements. For example, centralization of accounts receivable may have a negative impact if the client relationships suffer due to reduced local contact and expertise. In these cases, a careful evaluation would be required to determine if centralization for this function is appropriate.

Other situations may result in a hybrid arrangement where decentralized and centralized models co-exist and complement one another. This is often called a hub and spoke model that follows a centralized construct that allows spokes to address local/regional needs or considerations.

Regardless of the model and path that is right for your company, it's important to understand your company's culture and willingness to change. Direct ownership and commitment from executive management and a robust change management discipline are critical components of a successful transition to a more centralized environment.

Considerations

To help ensure a smooth transition, treasurers should consider potential impacts:

- What technology is needed? Can legacy systems be integrated?
- How complex is your organizational structure, and is there flexibility to embrace centralization?
- How will legal, regulatory or tax arrangements be impacted?
- Do you have full executive and local management buy-in?
- Are ongoing costs factored into the cost/benefit analysis?
- How will this affect bank and vendor relationships?
- Does your company's culture embrace change?

Common centralization structures

Shared service center (SSC)

An entity that provides a concentrated support of activities that are traditionally distributed across business units within an organization. When considering the location of an SSC, it's important to balance low-cost location with areas that have pools of skilled labor and a favorable time zone.

In-house bank (IHB)

A centralized structure that processes intercompany transactions and concentrates these transactions, including payments and receivables, through one channel. IHBs enable the company to self-fund across multiple locations with cash available at the group level, resulting in reduced reliance on separate funding sources.

On behalf of (OBO)

A structure that occurs when a dedicated entity within a corporation uses its own bank account to make payments (POBO) or receive payments (ROBO) "on behalf of" the other corporate entities. This can significantly reduce the number of bank accounts held globally; however, the implications of closing local accounts must be considered.

Intercompany/netting

A practice that uses general ledger (GL) functionality to replace actual internal payments between entities with GL accounting transactions. Netting consolidates transactions between corporate entities before establishing and settling intercompany transactions, resulting in fewer bank account transactions and their associated costs. Additionally, the centralized oversight could improve risk management. A single instance ERP and appropriate accounting expertise are required.

Outsourcing

A contract with a third party to perform services in an effort to reduce costs and gain efficiencies.

Centralizing treasury operations

Working capital optimization

- Optimize internal funding sources
- Simplify liquidity structures
- Improve cash flow forecasting
- Optimize risk/return on investments

Control and compliance

- Standardize and better manage core processes
- Optimize information and reporting
- Improve visibility

Cost reduction

- Rationalize banks, accounts and bank fees
- Remove duplicity
- Automate

Cost efficiency

- Manage scale and productivity
- Automate with STP
- Leverage technology – digitization

FX and risk management

- Centralize oversight and execution
- Reduce transactions – netting

Defining your journey

Centralizing treasury activity can benefit most organizations, however, the process must be customized to fit the organization's objectives and strategic goals. Your banks, technology providers and other vendor relationships may be able to help you determine the optimal structure for your organization.

GTS Advisory

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GTS Advisory insights can include subjects such as working capital optimization, M&A, operating models, risk management, capital strategy and innovation. Support is often hands-on and on-site, and our advisors frequently help clients build strategic treasury roadmaps, inform capital or hedging strategies, or prepare change management business cases. We deploy the team as necessary to help address short-term challenges, as well as to realize long-term treasury objectives.