

In-house banking: Is it right for your business?



Utilising in-house bank models

The use of in-house banks is increasing across the world, especially amongst large global multinationals. In this paper, we examine the use of in-house bank models in more detail including the benefits, challenges and specific issues relating to use of payment-on-behalf-of (POBO) or receipt-on-behalf-of (ROBO) structures.

Introduction to in-house banking

We use the term in-house bank (IHB) to describe a dedicated finance or treasury entity that provides financial services such as cash management, risk management (FX, interest rate, and commodity hedging), core funding and working capital to business units or affiliates within an organisation.

In the classical treasury model, treasury arranges banking facilities on behalf of affiliates. Banks contract directly with the affiliates even though treasury may negotiate the facility agreements and manage activities such as loan draw downs and FX trades on behalf of the affiliates.

Under the IHB model, the IHB contracts directly with affiliates to provide them with loans, FX, cash management, and other services. In turn the IHB buys these services from external banks where necessary but tries to internalise as many transactions as possible.

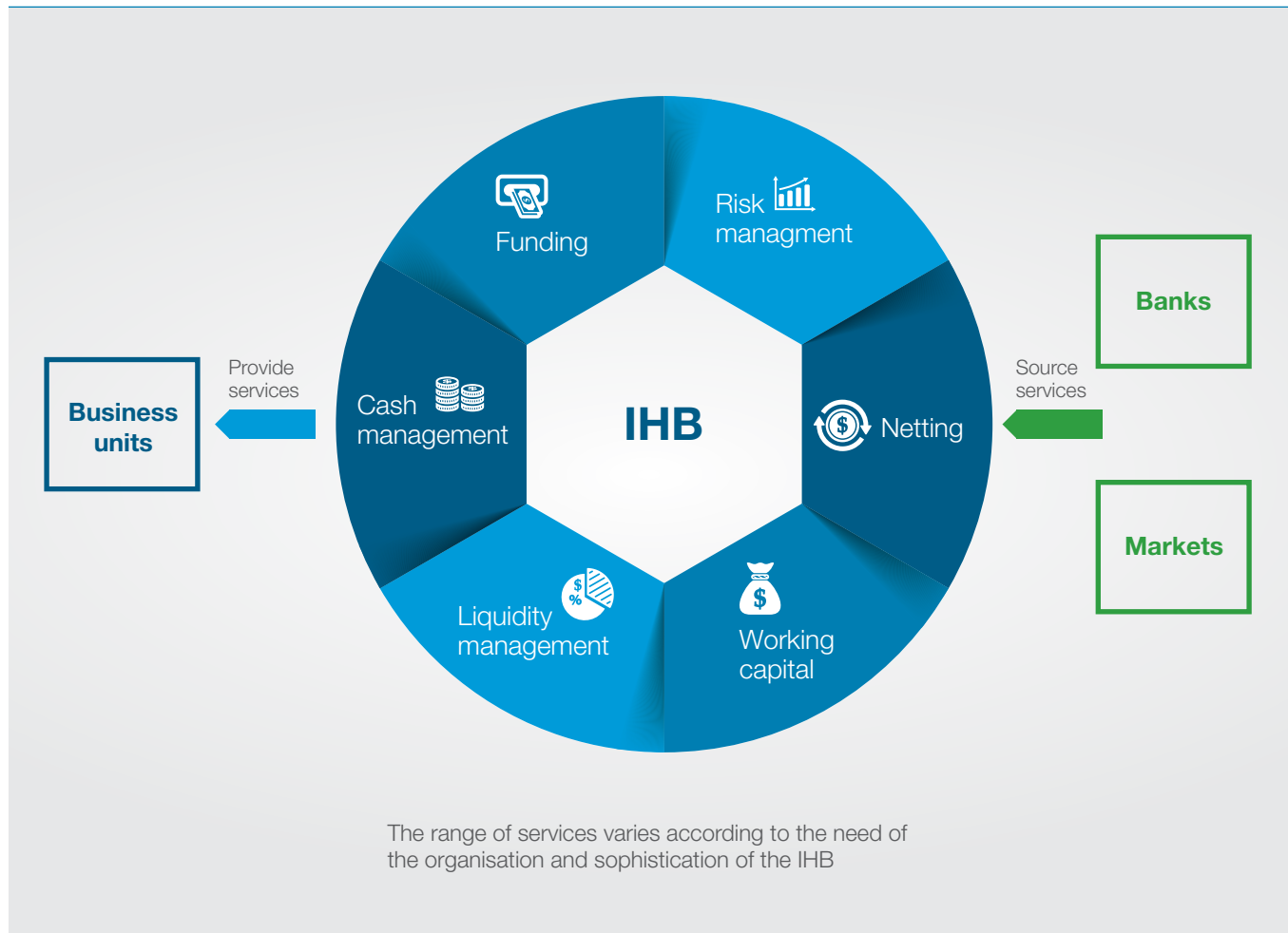
Scope of activities

Subject to regulatory constraints, an IHB may provide a wide range of financial services to affiliates including:

- Short and long term funding facilities
- Cash management services such as in-house bank accounts, payments and collections
- Deposits and investments
- Risk management services including FX, interest rate and commodity hedging
- Supply chain finance
- Guarantees and performance bonds
- Customer finance

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Range of services offered by an IHB



Intercompany funding, cash management and FX are the most common activities covered by IHBs. Some are more sophisticated and deliver a broad range of financial services normally associated with established commercial banks.

Benefits of the IHB model

Subject to local regulations, the benefits of IHB model can be considerable as illustrated in the following table.

Customised Services	<ul style="list-style-type: none"> Financial services can be customised to the specific needs of the business units whilst driving strong alignment of internal processes and practices within the group
Capital Efficiency	<ul style="list-style-type: none"> Centralised borrowing leads to better credit line management and usage at lower costs IHB can vary loan terms with affiliates to reflect differential credit risk of internal borrowers whilst eliminating credit arbitrage charged by local banks
Operational Efficiency	<ul style="list-style-type: none"> Centralisation of financial activities drives process standardisation, economies of scale and straight-through processing Intercompany payments can be internalised and settled on the books of the IHB, reducing the use of external clearing systems and lowering bank fees Positive impact on downstream processes such as bank account reconciliation, accounts receivable invoice matching and settlement processing from improved information and data matching
Liquidity Optimisation	<ul style="list-style-type: none"> Processing of payments and collections through a centralised set of bank accounts managed by the IHB concentrates liquidity at the centre without need for a complex pooling structure Use of intercompany loans to self fund operations can be maximised thereby reducing debit/credit spread otherwise earned by banks through local deposits or short term loans
Reduced Risk Management Costs	<ul style="list-style-type: none"> Internalising FX trades and other hedging activities facilitates internal netting of exposures IHB only covers its net, not gross, positions with the market
Management Control	<ul style="list-style-type: none"> Improved visibility of positions and flows across the group leading to improved forecasting, controls and decision making
Financial Savings	<ul style="list-style-type: none"> Elimination of credit differential on local borrowings Elimination of bank debit/credit spread on short term loans/deposits Reduced bank fees from reduction in bank accounts, internalisation of intercompany payments, and consolidation of payment/collection activities Cross-border payment originating from affiliates can be converted into local ACH type payments saving on bank fees Reduced FX spread on trades netted through IHB Reduced borrowing costs on under/overfunding of positions Savings in labour costs through introduction of streamlined and automated settlement processes in IHB Savings in labour costs from improved downstream processes such as bank account and accounts receivable (AR) invoice reconciliation

Important considerations

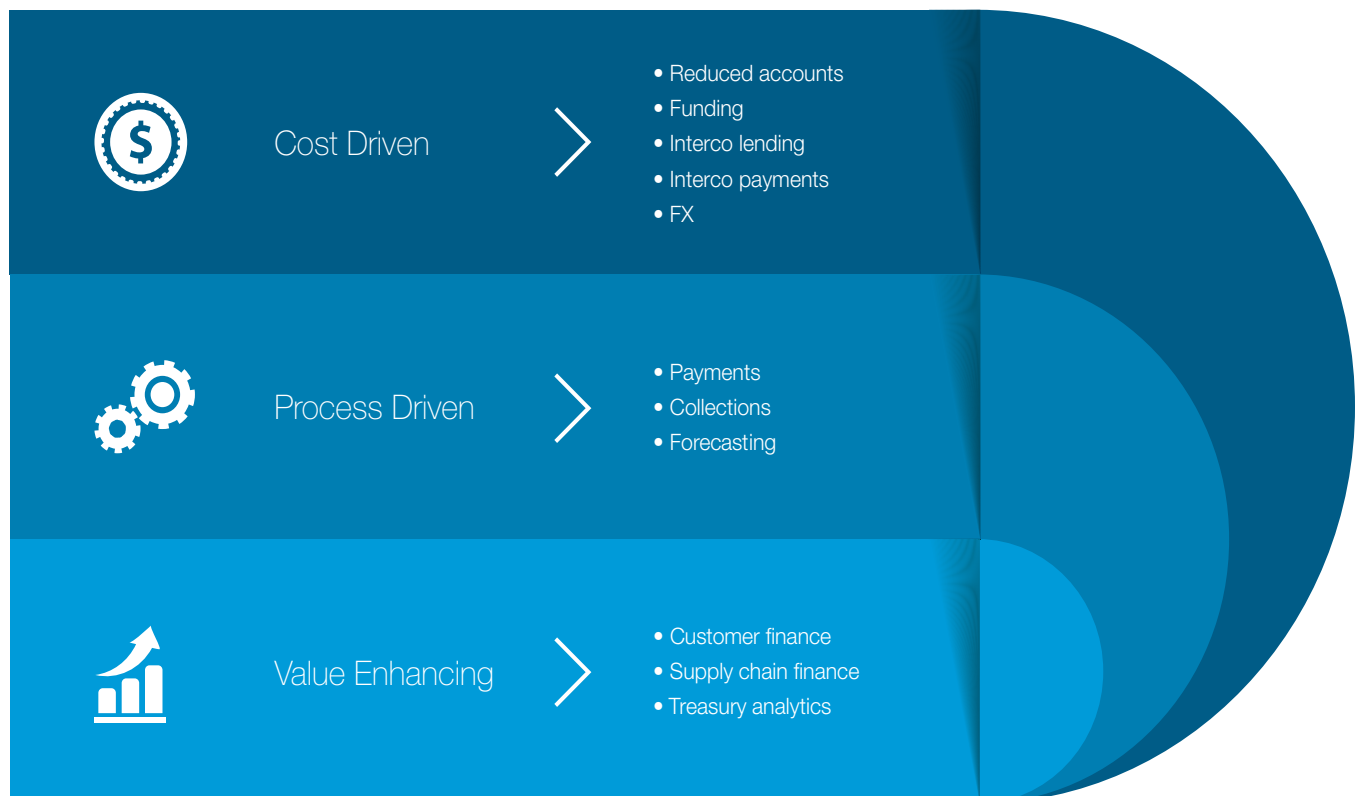
Some of the important considerations when establishing an in-house bank include:

- Scope of IHB activities
- Reengineering of internal processes
- Complex system requirements
- Use of POBO/ROBO structures
- Geographic coverage
- Legal, tax and regulatory restrictions
- Significant investment spend
- Resistance from the business over perceived loss of control
- Project resourcing

Scope of IHB activities

The scope of IHB activities is often driven by a mix of different objectives covering cost, process improvement and value creation.

Hierarchy of IHB activities by key drivers



Many IHB projects are initially driven by a strong cost-efficiency objective. Hence, the IHB tends to focus on the areas that will drive the biggest initial cost savings and then expands to cover other areas as the initial round of savings is realised.

A smaller group of IHB projects are more aspirational in nature, i.e. creating a “world class” or “next generation” treasury function. These projects tend to push the envelope furthest in terms of both maximising the scope but also sophistication of the model.

Regardless of what the underlying drivers may be, the following questions can help a company define the scope of the IHB that they have in mind:

» **What is the alignment of the IHB model to the overall company objectives?**

Ideally the IHB model should align with the most important business objectives. For example, building a highly centralised IHB model in an organisation that favours business unit autonomy over head office control is unlikely to be successful unless it has a very strong focus on meeting the needs of the business units with an attractive range of services.

» **Does your company have the necessary technical sophistication to support the proposed IHB model?**

Making the big leap to an advanced IHB model could be difficult and unrealistic if the level of technical know-how across treasury, tax, legal, accounting and technology is limited. Unless the organisation is willing to invest in outside consultants, it may be wiser to start off with a more basic model, gain experience and then expand the scope of the IHB over time.

» **What is the timeframe for delivering benefits?**

A shorter timeframe within which benefits need to be realised would necessitate adopting a simpler IHB model at the outset, with a staged implementation of more sophisticated services to follow once some “quick wins” have been delivered.

» **Will the IHB cover international flows only or in-country flows as well?**

If the company’s objective is to just cover the major international flows/exposures, then the IHB model is likely to be far simpler than if it were to cover in-country operations.

» **What key benefits is the company trying to realise?**

If main benefit sought is cost savings then the focus should be on those areas that will drive the biggest cost savings or returns. This would generally be cash management services, intercompany funding and FX. Conversely if the key benefits sought are things like control, improved information, and risk mitigation, then the scope of activities could be much broader.

Process redesign

Establishing an IHB normally means redesigning processes to support the new model including:

- Cash flow forecasting and funding
- Liquidity management structures
- Payments and collections flow via IHB
- Deposit-taking and investments
- Intercompany loan accounting
- FX order capture, execution and accounting
- Intercompany and FX netting

This could be a 6-18 month project depending on the scope of the IHB. If some of these processes are already centralised, the level of process redesign might be more limited.

Technology requirements

In-house banks normally require sophisticated, industrial grade software to support their operation including the following core functionality:

- **Cash management module** for liquidity management, treasury settlements and bank statement management
- **Risk management module** to support exposure forecasting, netting, trade execution, hedge valuation, effectiveness testing, and accounting
- **Payment factory** capabilities to support POBO/ROBO processing of accounts payable/accounts receivable files
- **IHB bank account ledger** to support delivery of individual bank statements to participating affiliates
- **Intercompany loan tracking** to support intercompany lending activities, interest accruals and withholding tax management
- **Loan and Investment modules** for financing and investment activities

This functionality can be typically sourced in three different ways:

- » Industrial-grade **treasury management system** (TMS) with full IHB capabilities
- » Combination of **TMS** and specialised software to support **payment factory** capabilities. The specialist payment factory software manages the transactional payment and collections flow whilst the TMS handles the core treasury functionality
- » **ERP system** with comprehensive treasury/IHB functionality

Another critical area is bank integration which is typically achieved by dedicated host-to-host connections with each major bank or via a single SWIFT connection. SWIFT connectivity can be achieved via direct connection to SWIFTNet or via a SWIFT Service Bureau. Both support the efficient exchange of payment files and bank statements on a straight-through process (STP) basis for multiple payment types and currencies across the world. FX confirmations, term deposits, bank guarantee requests and security trades may also be sent via these methods depending on the sophistication of the banks involved.

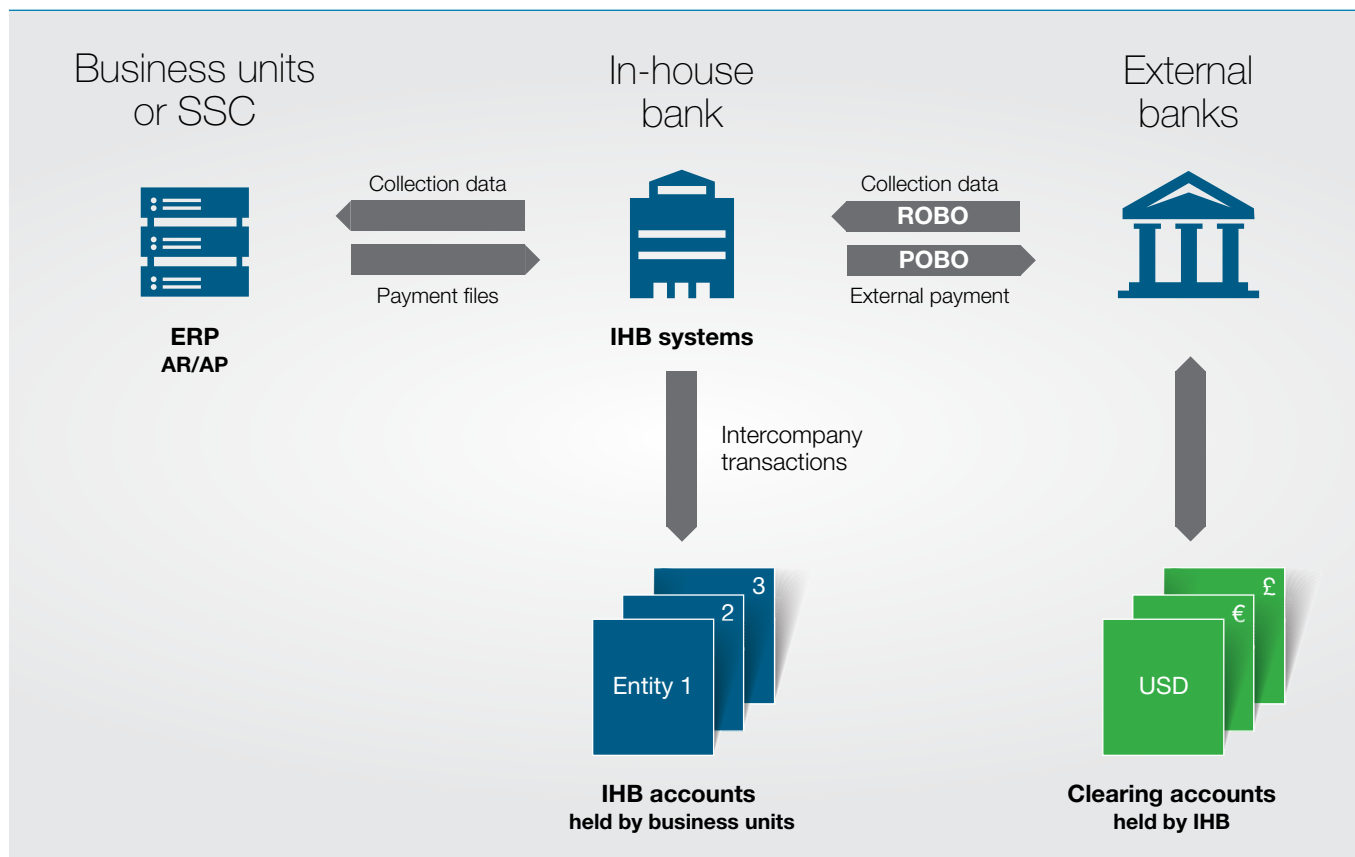
Adoption of the ISO 20022XML messaging standard is rapidly becoming the preferred option for file formats due to a high degree of standardisation across banks and support for double-byte characters such as simplified Chinese.

Use of POBO/ROBO structures

The use of so called POBO/ROBO structures are often at the core of the in-house bank but can often be confusing in terms of their application across different markets. The central premise of POBO/ROBO services is that the IHB acts as an aggregator and processor of payments and collections for group affiliates:

- Payment-on-behalf-of or POBO refers to a situation where the IHB executes payments of behalf of affiliates using a bank account owned by the IHB
- Receipts-on-behalf-of or ROBO refers to a situation where the IHB receives collections on behalf of affiliates using a bank account owned by the IHB. This is also sometimes referred to a COBO or collection-on-behalf-of

Process flow of POBO/ROBO structures

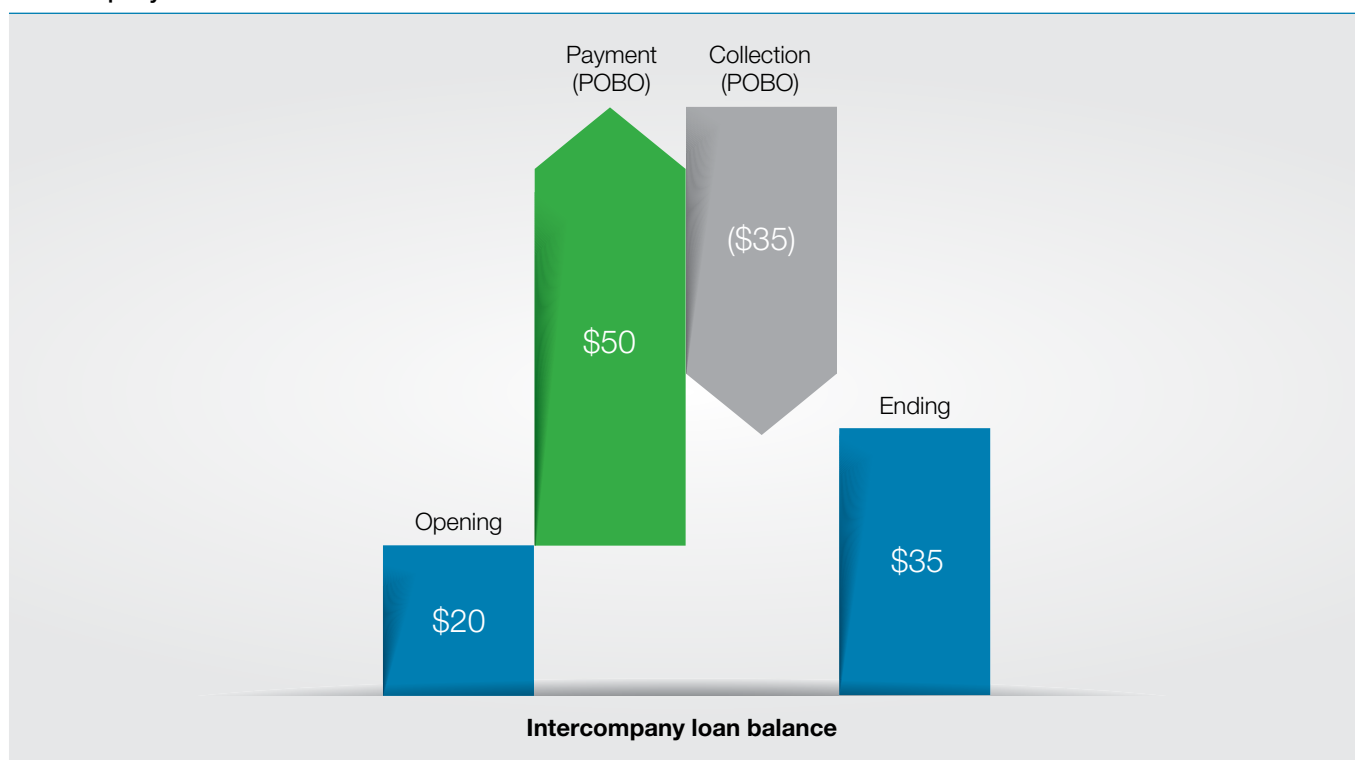


The use of a single account for each currency enables the liquidity positions (i.e. excess cash balances and overdrafts/short term borrowings) of the different affiliates in the group to be collapsed into a single account or position, greatly simplifying liquidity management, forecasting, and funding decisions. However, this may give rise to the creation of intercompany loans:

- When the IHB makes payments on-behalf-of other entities, it may create intercompany loans payable by the other entities to the IHB, and
- When the IHB receives collections on-behalf-of other entities, it reduces the amount of the intercompany loans payable by the other entities to the IHB or creates a deposit

In fact the exact characterisation of the transactions depends on the applicable regulatory environment and incorporation status of the IHB. Where the IHB is a non-financial corporation these transactions may be recorded as intercompany loans. Conversely, where it is registered as a finance company, the transactions may instead be recorded as deposits and withdrawals.

Intercompany loan scenario



The interest that is payable on the daily balance of the loans/deposits may then attract interest withholding taxes in some jurisdictions.

In an ideal world, the most efficient POBO/ROBO structure uses a single account per currency. If transactions are restricted to high value wires, the various accounts could be based in a multi-currency centre such as London or Hong Kong.

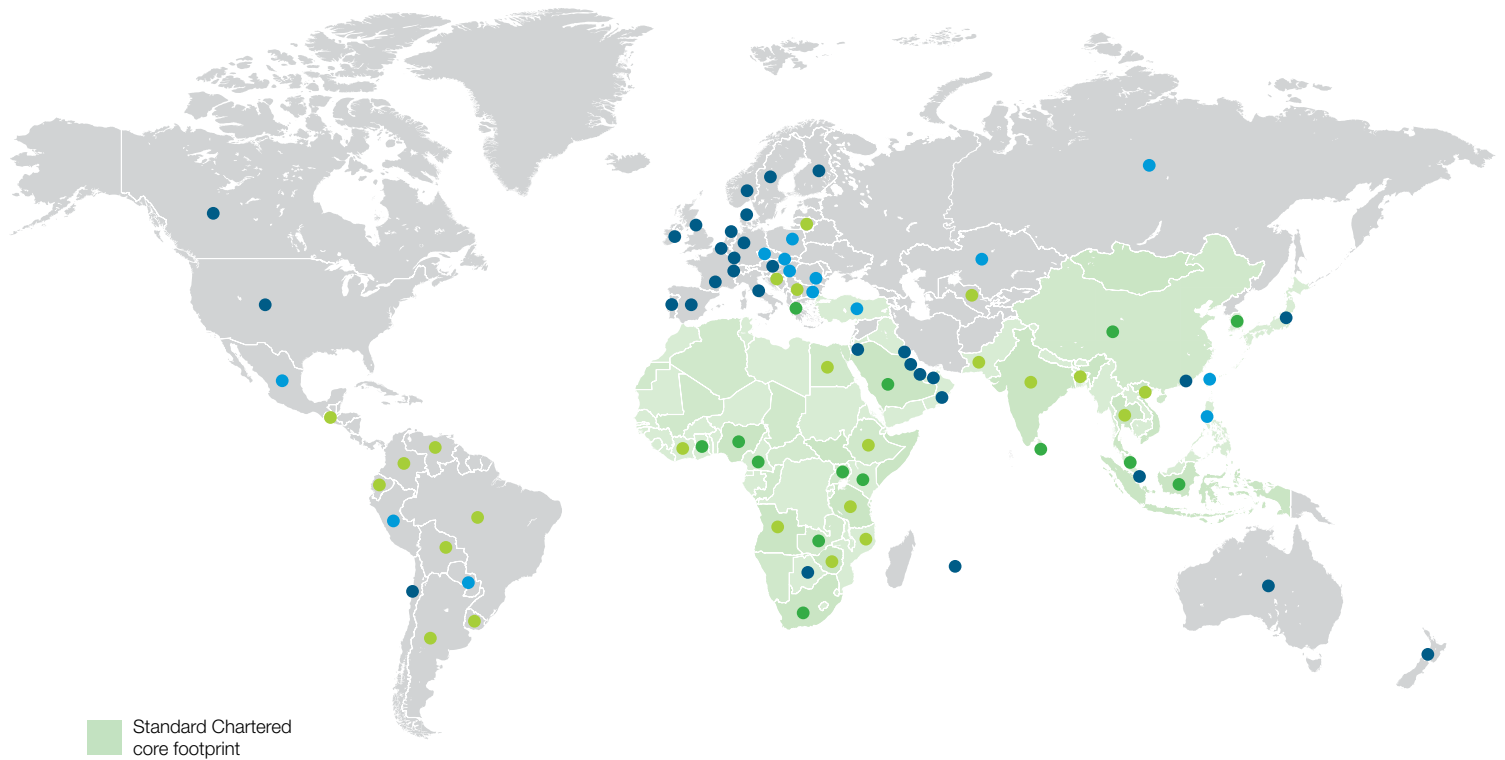
However, if there is need to process local cheques and ACH type payments, then the accounts would need to be located in the relevant country to access the local clearing systems. Hence, the use of non-resident accounts held onshore in the name of the IHB entity.

Geographic considerations

In practice, there are various regulatory and operational issues that effectively limit the use of POBO/ROBO in some markets. Therefore, different variations of POBO/ROBO models have evolved to cater for different markets.

Model	Market type	Description of Model	Market Characteristics
Global POBO/ROBO	Least restricted	IHB processes local and foreign currency payments and collections through its own accounts for entities in markets with the fewest restrictions on cross-border transactions	<ul style="list-style-type: none">• Limited local and foreign currency restrictions• Intercompany lending is allowed• Local currency accounts can be held offshore by IHB (if access to local clearing systems is not required)• Non-resident accounts can be held onshore by IHB with no restrictions on use (if accessing local clearing systems)• No pre-approval requirements for import and export transactions• No requirement to match name on invoice with name on payment/receipt
Foreign Currency POBO/ROBO	Moderately restricted	IHB processes foreign currency payments and collections through its own accounts for entities in markets where there are moderate restrictions on cross-border foreign currency transactions	<ul style="list-style-type: none">• Limited foreign currency restrictions• Intercompany lending in foreign currency is allowed without requirement for pre-registration of amount and tenor of loan• Foreign currency accounts can generally be held offshore by IHB• Non-resident accounts can generally be held onshore by IHB with no restrictions on use• No pre-approval requirements for import and export transactions• No requirement to match name on invoice with name on payment/receipt• No forced repatriation and conversion of foreign currency receipts to local currency• May be restrictions on ROBO transactions in some countries especially for non-resident account structures
Local POBO/ROBO	More restricted	IHB processes payments and collections through a central account held by a local entity. This generally applies to markets where there are cross-border restrictions but onshore transactions are less restricted	<ul style="list-style-type: none">• Foreign currency restrictions• Intercompany lending in local and foreign currencies is not allowed with offshore entities but is allowed between onshore entities• No requirement to match name on invoice with name on payment/receipt
Process Transactions Only	Highly restricted	POBO/ROBO is not allowed	<ul style="list-style-type: none">• Payments and collections must be processed through accounts held by each legal entity• May still be possible for the IHB to process the payment files but some level of payment authorisation would typically need to happen onshore

These hybrid structures enable IHBs to process payments and collections on a global scale. However, careful due diligence is required for each market as there are often local operational nuances, frequent changes to regulations, approval and or reporting requirements, or implications from a legal, tax, or accounting perspective that may result in different outcomes for different organisations.



Least Restricted

Europe

Austria | Belgium | Denmark
Finland | France | Germany
Ireland | Italy | Luxembourg
Netherlands | Norway | Portugal
Spain | Sweden | Switzerland
United Kingdom

Americas

Canada | Chile | United States

Asia

Australia | Hong Kong | Japan
New Zealand | Singapore

Middle East & Africa

Bahrain | Botswana | Jordan
Kuwait | Mauritius | Oman | Qatar
UAE

Moderately Restricted*

Europe

Bulgaria | Czech Republic
Hungary | Poland | Romania
Russia | Slovakia | Turkey

Americas

Mexico | Paraguay | Peru

Asia

Kazakhstan | Philippines
Taiwan

More Restricted

Europe

Greece

Asia

China | Indonesia | Korea
Malaysia | Sri Lanka

Middle East & Africa

Cameroon | Ghana | Kenya
Nigeria | Saudi Arabia
South Africa | Uganda | Zambia

Highly Restricted

Europe

Croatia | Lithuania | Serbia
Ukraine

Americas

Argentina | Bolivia | Brazil
Colombia | Ecuador | Guatemala
Uruguay | Venezuela

Asia

Bangladesh | India | Pakistan
Thailand | Uzbekistan | Vietnam

Middle East & Africa

Angola | Côte d'Ivoire | Egypt
Ethiopia | Mozambique | Tanzania
Zimbabwe

* May be some restrictions on ROBO transactions in some markets

Regulatory issues

Various regulatory issues can effectively restrict the use of POBO/ROBO structures, intercompany lending and hedging activities in some markets. Some of the typical issues that should be evaluated include:

- **Currency controls**

The use of currencies offshore is restricted in many markets and this effectively limits the use of offshore IHB structures, although it may still be possible to use a local entity to process transactions.

- **Intercompany lending**

Some jurisdictions have limits or outright bans on intercompany loans, especially cross-border loans in the local currency. There might also be specific rules in terms of documentation, approvals, reporting, tenor, and interest rate levels.

- **Related party interest**

High rates of interest charged on cross-border intercompany loan positions may be viewed as profit shifting or there could be specific rules or even prescribed interest rates for intercompany loans.

- **Withholding taxes**

Some countries levy withholding tax (WHT) on intercompany loan interest received by an offshore entity although foreign tax credits available to the IHB may limit their impact. Hence, these structures require careful vetting by tax advisers and extensive modelling of cash flows to determine financial impacts.

- **Thin capitalisation**

Many countries impose a cap on the level of borrowing or gearing for companies that may effectively put an upper limit on the total level of intercompany loans.

- **Non-resident account restrictions**

In some countries the use of non-resident accounts may be limited to a narrow range of purposes such as injection of capital or receipt of dividends. In other locations “lifting fees” may make their use uneconomic. In these cases the IHB may need to use an account held by a local entity to process transactions.

- **Registration**

In some markets the IHB may need to register as a financial institution in order to provide financial services. This is common in some parts of Western Europe (e.g. Germany) as well as Asia (e.g. China, Korea). As a result, the IHB may have certain capital, reporting and operational requirements that it needs to meet.

Other issues

There are other issues that can also impact the practical operation of IHB structures:

- **Management fees**

Some countries place limits on the kind of fees that can be paid to an IHB for services rendered. Hence, independent legal and tax advice regarding “arms length” fee arrangements is important.

- **Data restrictions**

Some markets have strict regulations on the location of company data requiring the IHB to replicate systems, hold data locally or exclude the country from the IHB structure.

- **Limited clearing information**

Some clearing systems are unable to carry any information about the underlying paying party creating potential issues recognising receipt of payment or raising issues of “payment masking” leading to a block on these types of payments.

- **Central bank reporting**

Some central banks require additional information about the purpose of payment transactions. This may require enhancement of IHB systems or reporting to meet these requirements.

- **Special payments**

Payment of payroll taxes, customs, duties and other statutory payments often require access to special clearing systems or offline lodgement processes. Whilst banks are increasingly offering services that enable these to be executed centrally by an IHB, some level of process customisation may still be required.



Leveraging bank technology and know-how

Banks like Standard Chartered have made significant investments in technology and services that can greatly assist the efficient operation of IHBs. These include:

- Connectivity via proprietary host-to-host or SWIFT Net to enable processing of payments and collections from a centralised IHB platform across the world
- Reconciliation tools such as virtual bank accounts and auto-reconciliation software that can help IHBs automatically allocate collections to both affiliates and customer invoices
- Linkages to specialist customs, duties and tax payment systems that enable automation of these payments from a central location
- Automation of low value FX transactions at a pre-determined spread thereby reducing overall transaction costs

Standard Chartered also has dedicated team of former treasurers who have significant experience developing and implementing some of the largest, most complex and well-known IHB structures in the market today.

Summary

IHBs can drive lower funding, FX and operational costs through increased process standardisation, and higher efficiency. They also support improved visibility and control over positions. However, aligning the scope of activities to core business objectives and having a strong understanding of the legal, tax, accounting and technology issues is critical to developing a successful model.

Standard Chartered has a dedicated team of former treasurers who have significant experience developing and implementing some of the largest, most complex and well-known IHB structures in the market today.



Victor Penna

Managing Director, Head of Treasury Solutions, Transaction Banking

Victor Penna is the global Head of Treasury Solutions, a treasury consulting unit within Standard Chartered's Transaction Banking unit. He leads a team of former Treasury executives who are based in key financial centres across the globe. Victor has nearly 30 years of banking, finance and consulting experience including senior roles at Citibank, J.P. Morgan and Standard Chartered. He has advised many leading corporations on sophisticated financial and treasury related structures including the design of several high profile in-house banks for Fortune 100 companies.

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Bangladesh	Nigeria
Botswana	Oman
Brazil	Pakistan
Brunei	Peru
Cambodia	Philippines
Cameroon	Qatar
Canada	Russia
Cayman Islands	Saudi Arabia
Chile	Sierra Leone
China	Singapore
Colombia	South Africa
Côte d'Ivoire	South Korea
Egypt	Spain
Falkland Islands	Sri Lanka
France	Sweden
Gambia	Switzerland
Germany	Taiwan
Ghana	Tanzania
Guernsey	Thailand
Hong Kong	Turkey
India	Uganda
Indonesia	United Arab
Iraq	Emirates
Ireland	United Kingdom
Italy	United States
Japan	Uruguay
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