Centralized vs Decentralized Financial Risk Management

Abdullah Alali
01 April 2021

It is fair to assume that centralized corporate treasury management is more operationally efficient than decentralized. But increasing economic, regulatory, and socio-political uncertainties magnify monitoring complexity for financial risk managers in a centralized treasury. In this capricious environment, decentralizing some financial risk management activities could rapidly enable subsidiaries to respond to changing economies. So which approach should you choose? In this bulletin, we cover different treasury management approaches for financial risk management and ask, is there an optimal path?

Financial Risk Management Reformation Is Often Inevitable

All entities realize at some point that changing how they manage financial risks is inevitable. What worked for a single entity's SAR 100 million exposure will fail for a multi-entity portfolio of over SAR 10 billion. Yet centralization may not always be the solution. In some instances, implementing a decentralized financial risk management approach yields better outcomes.

> **There is no globally defined best practice that fits all business types. Instead, designing an optimal financial risk management approach often requires tailoring to an entity's needs.**

Consider a multinational corporate Group with subsidiaries across the United States, South America, Europe, and Asia. The Regional Treasury Center (RTC) in South America could be better positioned to reduce the cost of hedging FX transactions given their close relationships with hedge providers. There is no globally defined best practice that fits all business types. Instead, designing an optimal financial risk management approach often requires tailoring to an entity's needs. Thus, optimization can entail both centralized and decentralized approaches.

Why Opt for a Centralized/Decentralized Approach?

We rarely see a corporate treasury survey where respondents adopting a centralized treasury management approach represent the minority. A centralized treasury function brings many advantages. Similarly, centralizing hedging activities is also common due to these key benefits:

- Enhance visibility into the Group's exposure and identify neutralized risk factors (Natural on-balance sheet hedges).
- Better alignment with the Group's risk tolerance.
- Increase operational efficiency by reducing redundancies.
- Reduce the cost of hedging strategies through leveraging the Group's credit profile.
- Avoid subjectivity and speculative approaches by profit-making entities (operating entities).
- Better visibility into cash flows.

However, centralized treasury management is no cure-all. Some financial risk management activities are better delegated to operating entities due to local regulations, accounting implications, regional bank relations, and business needs. This often requires decentralizing some financial risk management tasks, which brings its own benefits:

- Adherence to local regulatory requirements.
- Better alignment with applicable accounting standards.
- Active monitoring of lender covenants and limits.
- Reducing costs of hedging for illiquid assets.
- Leveraging regional hedge providers' relations to facilitate hedging programs.
- Immediate response to crisis and market shocks.

Optimizing Financial Risk Management

Optimization is mainly a function of an entity's objectives. If aiming to better align the outstanding exposure with an entity's risk tolerance, we advise centralizing financial risk identification, quantification, and hedge strategy selection. Yet decentralizing hedge execution can sometimes be commercially advantageous.

In FX risk management, for example, the holding entity could reduce FX risk by determining any natural intercompany exposure offsetting opportunities. Meanwhile, a subsidiary could reduce the cost of implementation by leveraging its relationships with regional hedge providers (assuming an illiquid underlying currency). Additionally, the concerned reporting entity might better resolve conflicts between economic risks and accounting risks (while a subsidiary might be concerned with FX transaction risk, the holding entity could be worried about translation FX risk).

Ultimately, optimizing financial risk management depends largely on an entity's business needs, risk management objectives, regulatory and reporting requirements, accounting implications, technology advancement, and the size and capabilities of operating entities.

Ultimately, optimizing financial risk management depends largely on an entity's business needs, risk management objectives, regulatory and reporting requirements, accounting implications, technology advancement, and the size and capabilities of operating entities.

Common Treasury Management Approaches

Shared Service Center (SSC): It is the center where treasury activities, including financial risk management, are aggregated. Employees in an SSC typically dedicate themselves to having a fully rounded view of financial risk management activities, starting from risk identification and neutralization through implementation and reporting. SSCs often target operational efficiency through process improvements and better alignment with an entity's risk tolerance. SSCs are well-positioned to identify natural hedging opportunities. However, without an unambiguous risk management framework, sophisticated technologies, and risk quantification models, maintaining an eye for details under an SSC approach could be cumbersome.

Regional Treasury Center (RTC): A centralized regional center that a corporation establishes to manage all its regional treasury operations. An RTC aims to reduce country and counterparty risk, enhance adherence to regulatory requirements, resolve economic and accounting risk conflicts, align regional risk management activities to the Group's risk tolerance, dynamically monitor regional markets, and intervene in crisis management.

In-House Bank (IHB): An IHB is a step ahead of an RTC. An IHB is a single, legal entity that holds the Group's balances and acts as a market maker for operating entities and often establishes a risk-based Funds Transfer Pricing (FTP) mechanism. An IHB focuses primarily on reducing funding and liquidity risks by reducing the Group's reliance on external funding sources. As market risks transfer from operating entities to the IHB, the Group can take a portfolio hedging approach, optimally utilizing natural intercompany exposure offsetting opportunities and reducing hedging needs.

The Road to Optimal Financial Risk Management

Optimization is a two-way road; it is done both "top-down" and "bottom-up". The Group's risk culture and governance framework are often implemented top-down, starting from the Group's Risk Committee and Board of Directors. In comparison, the quantification methods, regulatory requirements, accounting implications, and operational considerations are usually established bottom-up, where a team from the operating entities and the Group Treasury can pioneer the build-up process.

Although the independence of your risk management function is the cornerstone of a robust second line of defense, cross-departmental communications are crucial in establishing a successful financial risk management function. Attain input from your operating entities, legal, tax, IT, accounting departments, and others to create a sustainable, dynamic, and efficient financial risk management function. Finally, avoid doing it all at once – forming and successfully implementing the optimal function is done best using a gradual, phased approach with the buy-in of relevant stakeholders often contributes to the successful implementation.

For more information, please contact Abdullah Alali, Associate Director at Ehata Financial, ***Abdullah.alali@ehata.com.sa***

ABOUT EHATA

Ehata is a specialist financial risk management advisory firm, licensed and regulated by the Capital Market Authority (license No. 17183-20). We are independent practitioners with expertise covering interest rate, foreign exchange, commodities, and derivatives. We leverage on our technical capabilities and market know-how to ensure that our clients get the excellence of the advice and the satisfaction that comes with it.

DISCLAIMER

Ehata Financial Company is authorized and regulated by the Capital Market Authority (license no. 17183-20). Ehata Financial Company may only undertake the financial services activities that fall within the scope of its existing CMA license. Principal place of business in Saudi Arabia: King Fahad Rd, Avenue Building, 5th Floor, P.O. BOX 241106, Riyadh 11322. The information contained in this article was prepared by Ehata Financial Company. Though the information herein is believed to be reliable, Ehata Financial Company makes no representation as to its accuracy or completeness. You should not rely solely on this communication when making a decision whether or not to enter into a derivatives transaction. If you are not an experienced user of derivatives, if you are not capable of making independent trading decisions and you do not understand the terms and risks related to derivatives transactions, you should refrain from entering into such transactions. You should consult your own legal, tax and accounting advisers with respect to any proposed derivatives transaction. Under no circumstances shall we or any of our associates or any of our associates' respective directors, officers, employees or agents, be liable for indirect or consequential losses including any failure to realize any profit, advantage or opportunity relating to the transaction or otherwise. The information contained in this article should not be reproduced in any form without the express consent of Ehata Financial Company. The information contained in this article from the sender shall not be considered as advice or solicitation to buy or sell any securities.