



frontiers in finance supplements

Take another look: Streamlining group structures
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FINANCIAL SERVICES

The crisis and subsequent recession are turning minds across all business sectors to cost reduction, efficiency and rationalization. In the financial services sector, the need to focus on the core business, simplification and divestment are increasingly common themes. In this context, many multinational groups are now scrutinizing their complex organizational structures, and coming to realize that significant savings can be secured from rationalization of the number of legal entities within the group.

Over time, a number of factors tend to increase the number of legal entities. Some of this is simple inertia: an acquisitive company will buy additional operating subsidiaries, often in different jurisdictions, and leave their existing legal forms in place. Sometimes, there are sound reasons – such as tax efficiency – for preserving separate entities. In others, legal separation is a means of shielding a parent company from potential liabilities elsewhere in the group.

However, very often the original justification for separate legal entities fades: tax regimes change, courts pierce the legal veil. At the same time, the costs of maintaining large numbers of different companies within a group can be very expensive. The direct costs of separate incorporation, filing, regulatory reporting, registration and management are just the tip of the iceberg. More far-reaching – although more difficult to quantify – are the costs of intra-group interaction and management, of intra-group trading regimes and of the legal, regulatory and financial infrastructure required to sustain a complex network of separate legal entities. Capital adequacy requirements and regulatory compliance can mean that the direct and indirect costs of maintaining

legal entities are even higher in the financial services sector than in other sectors.

A multinational group focused on streamlining, cost reduction and efficiency will almost certainly find great potential in legal entity rationalization (LER). Financial services companies facing pressure to divest non-core businesses may well find LER a necessary initial step. Proposals for the formulation of ‘living wills’, specifying how a financial conglomerate may be wound up in the event of catastrophic failure, may be another spur to action. Other triggers which may justify a thorough review include the impending implementation of a new shared service centre or a new IT system.

Because the ramifications of complex structures can extend across a group, and influence management actions in many functions, we often (but not always) see clients undertake a thorough review both of the costs of rationalization and the benefits, to develop a robust business case for change. Some clients see an LER process as a ‘no brainer’ and do not consider it necessary to create such a business case. Direct financial benefits in the regulatory, accounting, corporate tax and legal functions can arise from:

- fewer entities required to hold their own regulatory capital

Any complex organizational structure creates individuals with a vested interest in maintaining the status quo

- fewer company filings (regulatory returns, statutory accounts, corporate tax, indirect tax, payroll taxes etc.)
- fewer companies subject to annual audit
- reduced inter-company transfers of goods and services

Processing costs can be reduced and supplier purchasing benefits increased.

Combining two or more transacting entities reduces tax and regulatory compliance costs, transfer pricing complexity and risk. Consolidation of tax attributes (e.g. losses) may make it easier to control their future use.

It is important to note, though, that significant cost savings are unlikely to be achieved merely by eliminating dormant or almost-dormant companies. Major benefits follow only from combining active trading entities. This means that assets and liabilities need to be redistributed around the group, and so it is essential that such transfers are properly structured and controlled



from a tax, accounting and legal perspective. There are also likely to be individuals who are legally employed by such entities, and the transfer of their contracts of employment to other entities in the group needs to be carefully explored, along with issues of pensions, terms and conditions etc. Redundancies also need to be considered.

Legal, tax and regulatory issues arising in an LER project can include:

- assignment of customer and vendor contracts, licenses, leases and obligations
- transferability of regulatory permits, licenses, contractual rights and remediation obligations
- lender arrangements over asset collateral pools, negative covenants and other areas
- exposure of valuable asset pools and/or income streams to operational liabilities of affiliate entities
- cash trapped in foreign jurisdictions or within non-efficient cross-border structures

- preservation of net operating losses, tax credits, and other material tax attributes

With proper risk management, these issues can be addressed and steps taken to mitigate their effects. For example, the LER project can be structured from the beginning to identify and retain valuable tax attributes so that these attributes continue in the surviving entities.

A phased project plan is essential, beginning with identifying the strategic objectives and moving to develop a top-down vision of the optimal legal entity structure to emerge at the end of the process. Implementation planning needs to be undertaken by a broadly-based cross-functional team, in view of the knock-on implications of such changes across the group. Apart from providing external insight and expertise, an independent perspective can be especially valuable in these initiatives. Any complex organizational structure creates individuals with

a vested interest in maintaining the status quo, whose power or responsibilities may be damaged by change; a source of external challenge can help balance the interests of different stakeholders in the group and overcome resistance to beneficial change.

In the end, how far to push an LER initiative will be a question of judgment. At some point, the costs and risks of major legal and structural change may come to outweigh the potential benefits. But our experience with a number of large LER projects suggests that a typical large multinational that has not reviewed its structure recently should aim to reduce the number of separate legal entities by at least 50 percent in order to generate substantial direct and indirect benefits. It is time to look again at that long list of subsidiaries on the headquarter foyer wall.

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