



ARTICLE FOR GT NEWS

STRATEGIC DECISION-MAKING ON TREASURY OUTSOURCING

The decision to outsource some or most of the treasury function is indeed a strategic and important one, principally because the company is then dependent on an external third party for the provision of a critical service to it and its constituent entities. There are a number of strategic elements in the consideration and in the decision that need to be properly assessed before taking the outsourcing step.

However, in my experience, companies do take adequate time to consider the issues well, to satisfy themselves that it is a correct step for them and to develop a solution that will work well for them. Typically, this process from initial concept to decision will take six months plus, sometimes can be done in three months, and in exceptional cases can be completed in two weeks. We have had all of these experiences in my company.

So, what are the strategic factors that must be considered to lead to a sound decision?

Outsource or not

The obvious starting point is to make the decision in principle as to whether outsourcing is an option or not. In some organisations the business philosophy is that almost all functions are done in-house; often treasury management will be regarded as critical and sensitive and will not be outsourced. Sometimes there is an unstated culture which makes outsourcing unworkable. But more often than not, it is the personal position or interests of the CFO or Group Treasurer which will influence the decision.

However, equally, CFOs and Group Treasurers are often faced with business situations or resource issues for which they positively and proactively select the outsourced model as the best fit solution.

But in the tough cut-and-thrust of today's business world companies are pressured to consider outsourcing in many areas and indeed outsourcing everything other than the single core critical competence is now established as the efficient business model. So, now and in the future, even the reluctant CFOs and Group Treasurers will be faced with considering this option for the treasury function. Perhaps it is better that they take the lead by undertaking this consideration at their own discretion rather than being pressured to do so.

Objectives in Outsourcing

It is important that the objective or objectives that give rise to consideration of outsourcing are well established. This way a better solution is derived. In my experience, this is the range of objectives that companies work to:

- *To fill a resource or skills gap:* Companies who do not have an adequate treasury team in the corporate centre to undertake all of the treasury tasks that are needed, or where there is no treasury resource in place outside of the home country. Or where a new treasury activity is needed by the business for which the necessary skill does not exist in-house.
- *To free up scarce resource to focus on critical or strategic aspects of treasury:* Treasury teams are becoming smaller and smaller, yet there is more and more pressure to perform and to add truly significant value, requiring a focus on the strategic aspects. Outsourcing of some of the routine operations will free up internal resource for this purpose.
- *To achieve more value:* Many multinational companies, especially those that have globalised through several acquisitions over the last decade, find that there is much inefficient cash in the system, funding is not optimal, treasury risks are not managed, etc. These value wasting practices can be resolved quickly by an effective combination of in-house resource and outsourced partner resource. But more than just the obvious value enhancement possibilities, many smart CFOs and Group Treasurers are beginning to realise that they can better achieve the significant added value that is now required from them by bringing into play the expertise, experience and performance capabilities of an outsourced partner to complement in-house competence in the management of the high-end, strategic aspects of treasury.
- *To have better control of the high risk treasury activity:* The small size of many treasury teams or the dispersed nature of large multinational groups can mean that the essential controls over cash and treasury are inadequate. For example, in US the Sarbanes-Oxley Act puts an onus on the CFO to be in a position to have proper control of these areas. Controls can easily and readily be enhanced to meet the required standard through a combination of in-house and outsourced solutions.
- *To get access to better systems solutions:* Nowadays, treasury systems are available which can drive much enhanced efficiency and control in the treasury. However, the full systems enhancement project is quite expensive, starting at around EUR.5m, and the project will be quite disruptive for the treasury team over a six to nine month period. In an outsourced solution, the benefits of the outsourced partner's systems and IT infrastructure will be available more or less immediately, thus avoiding the investment and disruptive project.

Situations where Outsourcing Suits

There are specific business situations which tend to cause companies to consider outsourcing as a model to meet at least part of the treasury solution, as follows:

- Business spin-outs from large groups, where the new entity is left with no treasury resource.
- Mergers and acquisitions, where the existing team is too small or has not the full skills set to accommodate the new business situation.
- International expansion, which may give rise to a need for a treasury presence off-shore the country of the corporate HQ.
- Business and financial restructuring and headcount reduction, which requires a different approach to treasury resourcing.
- Financial position changes, where for instance a company changes from being very cash positive to being a major borrower, requiring new skills.
- Treasury technology investment, where companies are not in a position to approve the EUR.5m plus for the investment and seek alternative solutions.
- SPVs or Tax Vehicles, where companies set up legal entities to support certain types of treasury transactions, e.g. securitisation, or for tax management purposes – often it is appropriate that the business of these vehicles is conducted by an outsourced services provider. Control concerns, where the board or internal or external audit requires correction of the control deficiencies.

What to Outsource

In reality anything in the treasury area can be outsourced and indeed it is. However, my experience suggests that it is better practice to have some treasury capability in-house, ideally at least the Group Treasurer. But in effect all activities in treasury can be outsourced under the Group Treasurer's management.

The objectives setting process set out above will lead to an obvious determination of what should be or can be outsourced. The slicing and dicing of what is in-house/outsourced can be done in many ways and typically it is viewed in one of these ways:

1. By Strategic/Operational

| Outsourced | In-house |
|--|---|
| <i>Operational</i> | <i>Strategic</i> |
| Transaction Execution Confirmation & Settlement Reconciliations Reporting Accounting Systems/IT | Funding Risk Management Oversight Banking Relationship |

OR

2. By Functions

| Outsourced | In-house |
|---|---|
| <i>Mid & Back Office & Systems</i> | <i>Management & Front Office</i> |
| Confirmations & Settlement Reconciliations Reporting Accounting Systems | Funding Deal Execution Risk Management Oversight Interface with Group Entities |

OR

3. By Activity

| Outsourced | In-house |
|---|--|
| Cash Management Cash Fund Investment Fx Hedging | Funding Commodity Price Management |

OR

4. By Geography

| Outsourced | In-House |
|---------------------------------------|--------------------------------|
| Europe Middle East Asia/Pacific | North America South America |

Preparation of Activities for Outsourcing

I have often heard the comment that something which is not working well should not be outsourced, that the bad practice would be preserved in an outsourced solution. In other words, that the process has to be got fully efficient in-house before it can be outsourced. This is not true. In almost all cases, outsourcing is considered in the business situations or because of the problems described above and the in-house capability or capacity does not exist to meet the requirement.

In almost all of the outsourced situations that I am familiar with, the outsourced solution has been used initially to resolve a problem situation. And this works very well. However, it does require that the outsourced partner has the practical and comprehensive treasury expertise and experience to be able to deal with the issue, in effect an advisory or consulting capability as well as a treasury operations capability.

Some examples, two of my company's current clients had the initial requirement to devise, develop and implement a new cash management solution, because the existing one was unsatisfactory. Thereafter, the requirement was to monitor and manage the new system. Another client had a large cash pool which needed proper investment but did not have the skills in-house – the outsourced solution provided an immediate solution. Another client which was spun-out from a large MNC had extensive FX exposures which had to be tightly managed. The initial task was to devise and develop the approach and system to be used and then thereafter to operate it.

So, it is not the case that only efficiently operating existing processes can be outsourced; indeed the opposite is the case. This means that there is no particular need to prepare activities in advance of outsourcing. However, of course there is a need to be clear as to how all activities and processes will be undertaken in an outsourced solution and this is one of the key tasks in the consideration process described in the introduction above.

Which Outsourcing Partner

A key question. But to a large extent it is answered in the process covered by the “objectives” exercise and the “what” sections above. Clarity in these will suggest the type of partner to be selected. However, in addition some companies will have policy influences as to whom it prefers to play certain roles in the provision of banking, cash management and treasury activity.

The main choices to be made are:

- *Is a highly value adding solution preferred to a more operational routine, processing and administrative one?* Not all providers have the same capability in this respect. Most bank provider business models tend to focus on technology and processing – seeking the P x V model as they describe it – price by volume, while some of the independent providers will have the strategic highly value adding capability as well as the operational capability.
- *Is a group entity supporting approach needed, or a more back-room service?* Is there a need to be physically out-and-about among the group entities, helping them with problems and issues and providing treasury type advice, helping and taking on treasury type tasks for the controllers, as well as the usual centralised functions, ie, operating in much the same way as an in-house treasury, or is the need more to process high volumes of transactions? Again, providers will have different appetites and capabilities.
- *Do you want a customised solution or a packaged product?* Many companies see their treasury operations as unique to themselves and they will require a customised solution, while taking in the benefit of better practices that outsourced providers may have. They do not want to take or conform to a product type solution, where the company must change its requirements to fit the product offered. Banks tend to offer a product approach, while boutique providers are more open to customising.

- *Does the company favour a relationship bank provider or an independent provider?* There are many aspects to this issue and companies have differing preferences. Sometimes, the key relationship bank will be a major credit provider and can pressure the company to grant this additional fee earning role. However there are issues regarding suitability of a bank for such a role – effectively bringing your bank within your business; rewarding only one bank with this role, while there are several key relationship banks, especially in credit provision; actual and potential conflicts of interests; constraints on flexibility going forward; exposure to banks' changes of strategy.

There are also issues with independent providers, such as the company will not be previously known; often it is not a large organisation, more a boutique provider; difficulty in persuading the board or decision-maker to approve such a solution compared with the well-known relationship bank.

These are the factors and choices that a company must work through in deciding on the outsourced partner most suited to it. Better make this choice very well, because it must prevail for a long time. Take a very hard and objective view as to what really makes best sense for you.

Control and Security

This is often a major issue for companies contemplating the outsourced option. But the experience in practice is that this should not be a major concern. Outsourced providers, at this stage, will have best practice controls, indeed much better than those in an in-house treasury, other than perhaps the very large ones. They have devised solutions which effectively limit the potential for something to go wrong. It is very much in their interests that nothing does go wrong, since this would wipe out credibility and the business.

However, as part of the due diligence process, companies should focus on the robustness and effectiveness of the control and security arrangements in operation in the outsourced provider's operations. Take considerable time to walk-through the front, mid and back office functions and the internal management process, to satisfy yourself with the risks. Look for a customised control and security framework to meet your needs.

Nowadays, it is necessary for the company to be satisfied with the outsourced provider's Business Continuity arrangements – a routinely tested, well-off-site solution for both systems and technology and people. Another item for inclusion in the due diligence process.

What Cost

Cost outcomes will vary with the type of situation and solution. There will be significant savings to be achieved where significant investment in setting up a treasury function or satellite treasury function, or in putting in place the skills and technology needed to support the treasury function. In my experience, where an outsourced solution will have a start-up or investment cost of 100, an in-house alternative will have a cost of 450. This is where the main savings will occur.

However, there will also be savings in the ongoing operational cost in the outsourced solution, comparing like with like. This is because the outsourced provider will achieve economies of scale in resources and ongoing systems and market services costs. Again, in my experience, where an outsourced solution will have an ongoing cost of 100, the in-house alternative will cost 116.

This looks at the operational cost comparison only. In addition, the outsourced provider should bring further financial benefits through better return on treasury assets, reduced cost of treasury liabilities, transaction performance, input to strategy and risk management. However, it is difficult to quantify this in advance of being engaged in the activities.

Managing Service and Performance

Another concern for some companies – how can I manage the outsourced provider, its service and its performance? Again, at this stage, outsourced providers have developed templates and methodologies which do enable companies to effectively manage the outsourced solution. The proper structures, roles, planning and review processes, reporting and escalation and issue resolution procedures need to be developed between the outsourced provider and the company to the satisfaction of both, but especially the company. Again, in the due diligence process, the company should vet thoroughly the model operated for other existing clients and explore what will be customised for it.

My experience is that companies do take the time in the process leading to decision to be satisfied that they can have effective management. It is essential that a detailed documentation of the service to be provided and the tasks to be undertaken is done, that there is clear and comprehensive contractual documentation and that a documented process for management of the outsourced solution by the company is agreed.

I think these are the main strategic issues and factors in the outsource/in-house decision. I would welcome any additional inputs from other peoples' experiences, which would be added assistance to companies faced with this decision.

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