5.4.1 Outsourcing Treasury

Unit: Unit 1 – Treasury Strategy

Module: Module 5 – Treasury structure

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Summary: A look at different models for outsourcing and how the outsourcing decision might be made.

Keywords: application service provider, business service provider

Contents

1 Introduction 1
2 Application service providers 1
3 Outsourcing to a business service provider 2
4 The outsourcing decision 3

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Learning outcomes:

1. Two main models of outsourcing include application service providers (ASPs) and business service providers (BSPs).
2. Application service providers (ASPs) offer subscription services that enable companies to outsource system infrastructure and software.
3. ASPs use minimal internal IT resource.
4. Business service providers tailor a software package to its customer's needs and offers back-office solutions by undertaking many business processes. Classic treasury processes outsourced in this way include accounting, payments, reconciliation and many aspects of cash management.
5. The outsourcing decision is based on strategic, functional, core competency, and regional issues.
6. A provider must be heavily vetted along many dimensions.
7. Companies most likely to outsource treasury activities include start ups, spin offs, growth companies and those entering new markets.
8. A disadvantage of outsourcing is that it locks in a process and volume. Increases in volume may become disadvantageously priced.

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1 Introduction

We have discussed elsewhere how treasuries can be organised and structured. We have looked at the spectrum of possibilities from fully decentralised structures to fully centralised, and we have seen how centralised activities can be performed by dedicated operating units such as Shared Service Centres (SSCs) and In-House Banks (IHBs).

The process can be taken further in the search for efficiencies, by using either application service providers (ASPs) or business service providers (BSPs) to outsource non-core activity. This reading looks at the characteristics of each type of solution, and goes on to discuss possible motivations for outsourcing treasury activity.

2 Application service providers

Application service providers (ASPs) offer subscription services that enable companies to outsource system infrastructure. There is no need to purchase system software to run-back office operations. The application software resides on the vendor's system and is accessed by users through a secure web browser or other connection. ASPs usually offer services restricted to specific functionality and are typically limited in terms of the customisation that is possible.

The main advantage is enabling subscribers to avoid the expenses associated with installed software solutions, such as:

- licence purchase
- annual software maintenance costs (although there will be recurrent fees)
- upgrade costs (including installation and testing of the replacement version and the ASP may wish to charge more for the better product they are providing)
- maintaining automated links such as to ERP and data feed systems
- hiring dedicated IT resource attached to treasury

Other benefits include:

- the company does not have to worry about software integration issues
- software is updated regularly without impacting customers
- reliability, availability, scalability and security of internal IT systems are all improved
- IT costs are predictable in the form of monthly fees
- worldwide access for operating companies is possible over the internet, thus putting less strain on the intranet.
- the company can redeploy IT staff to focus on other projects that impact the bottom line.

There are some inherent disadvantages, however, including:

- there is usually very little customisation possible unless the company is prepared to pay for it

- the ASP may be providing a critical business function, thus limiting the company's ability to manage that function and increasing the company's risk and reliance on the ASP continuing in business
- continuing consolidation of ASP providers may cause changes in the product, type or level of service provided (although this is mirrored with purchased systems).
- integration with the company's other systems may be problematic.
- the company's data resides at a third party location and arguably outside the company's immediate control.

The type of services most frequently used are ones where the ASP automatically consolidates client treasury data across multiple bank accounts and services, thereby facilitating cash consolidation for payment and investment purposes. Also stand-alone functions, such as netting or reconciliation, are a perfect application for an ASP, and Treasury Management Systems are increasingly available as ASP offerings. This type of outsourcing is particularly interesting for smaller companies that lack the capital resources to buy the latest systems. Nevertheless, the services that ASPs offer are limited compared to those of traditional outsourcing providers or business service provider (BSP). In addition, there is an increasing overlap between BSPs, and ASPs, with many BSPs now providing ASP solutions as part of their overall service package.

3 Outsourcing to a business service provider

Outsourcing is the long-term contracting out of non-value-added business processes to a third party. A BSP differs from an application service provider in that it tailors a software package to its customer's needs and offers back-office solutions by undertaking most (if not all) business processes, such as payroll and bookkeeping. Small and mid-sized firms are attracted to BSPs because they have low start-up costs and low monthly fees.

What treasury functions can be outsourced? Basically any self-contained process activity, or activity where the level of decision making is limited or can be tightly controlled. For instance:

- all aspects of foreign exchange trading, deposit placements and funding
- foreign exchange risk evaluation
- cash forecasting, consolidation and planning
- treasury accounting and systems interfaces
- payment and confirmation processing
- full reconciliation of all relevant records (e.g. receivables matching)
- cheque issuance and other payment processing
- trade services
- invoice issuance / electronic bill presentment
- cash and liquidity management (netting, cash pool management, overdraft management, etc)

4 The outsourcing decision

The decision as to what functions to outsource can be taken on several levels:

Strategic: functions such as funding and risk management are retained in-house, while operational tasks such as transaction execution, accounting, confirmation and settlement are outsourced.

Functional: management and front office functions, such as funding, interface with group entities and deal execution may be retained in house, while back office and systems functions such as reconciliation and reporting are outsourced.

Core competency: there may be some activities which the company feels are core competencies such as funding or investments which are retained in-house, but other functions such as cash management, FX hedging and loan administration are outsourced.

Regional: in some regions where there are substantial operations, treasury may decide to manage that directly, such as in Europe and Asia, but where the operations are sparse, such as South America and the Middle East, treasury functions might be outsourced.

The decision on what to outsource comes down to who can add most value to which functions. If there is value added in-house (on whatever parameter), it should be retained. In other situations, a specialised treasury provider can add more value, and those functions are the ones best suited for outsourcing.

One of the major issues about outsourcing is the company's concern about loss of control and service levels. A properly structured outsourcing solution with service level agreements can actually improve control and service over an in-house treasury that lacks resources and expertise. Obviously, the selection of service provider is key; given the long-term commitment outsourcing represents, companies need to undertake a rigorous and formal selection process.

This process should cover issues such as:

- financial stability of BSP. the likely consolidation of the industry could lead to the demise of some of the weaker providers
- backup procedures in case of failure of the provider
- service levels and quality of delivery
- how to benchmark service delivery
- possibility to periodically review service contract
- audit trail and reporting
- professional indemnity insurance
- enforcement of confidentiality
- if linked to a bank or systems supplier, the BSP will need to provide assurances that there is no potential conflict of interest
- functionality on offer

- facility of integration with corporate systems and procedures
- potential for customisation
- ability to support international subsidiaries
- ability of system to adapt smoothly to new trends in the marketplace and changing corporate circumstances
- robustness of systems, security and risk management procedures
- facility of implementation
- implementation costs
- ongoing running costs

Ideally, companies should obtain references from existing users. They also should take the necessary time to familiarise themselves with the potential outsourcing partners to ensure they are fully comfortable with the way they operate and communicate. If agreement is reached, a service level agreement should be drawn up covering in detail all the points mentioned as well as issues such as authorised instruments and counterparties, credit limits etc. The company will also have to give detailed mandates to its relationship banks so that these are fully aware to what extent authority has been delegated to the BSP. Internally, the company has to ensure buy-in by all parts of the company, including all subsidiaries. The company which enters an outsourcing agreement should also have the necessary arrangements and resources in place to adequately manage the outsourcing partner during and after implementation of the outsourcing agreement. The extent to which companies are willing to outsource might differ, but naturally there are some core elements that need to remain in-house. Strategy, for one, can never be outsourced, nor can treasurers afford to rely entirely on their outsourcing partner to manage the company's risk.

Which companies are likely to outsource treasury activities? The most likely candidates to outsource are:

- start-up companies or spin-offs too small to warrant their own dedicated treasury team
- growth companies concentrating on core competencies, that are prepared to let a company with treasury as a core competence run their treasury operations for them
- companies entering in new overseas markets which may have treasury departments in other locations, but need control and segregation of duties, while being unable to justify the cost of a full blown treasury department

However, as the demands on treasury continue to grow, outsourcing also attracts companies with well-established treasury activities who wish to free up resources to work on higher value-added tasks.

Perhaps the key disadvantage of outsourcing is that it locks in a particular process and volume of process. The negotiations will have been conducted around particular volumes and structures and the economics justified on those strict grounds. However, few companies stand still and major changes such as divestment of a division or an acquisition, or new technology or even change of management can throw up huge challenges for treasury. Moreover these changes can alter the dynamics for outsourced operations completely, often making them no longer appropriate. Thus there is the challenge of dealing with the outsourcing provider as well as the challenges of change. Treasurers should consider

shorter rather than longer contracts for this reason and consider the implications of reversing an outsourcing decision.