# 5.6.6 Treasury Performance Measurement Exercise Answer

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| **Unit:** | Unit 1 – Treasury Strategy |
| **Module:** | Module 5 – Treasury structure |
| **Date:** | 1 September 2016 |
| **Summary:** | Answer to treasury performance measurement exercise. |

It looks like this treasury is concentrating on providing services to its operations but so far isn't really thinking very deeply about whether those services are what they need, whether they are adding value in those businesses and how they are contributing to overall risk management within Sysventure. It's probably the case that the treasury has been very busy on funding and putting in these central services as these are the 'obvious' services where treasury can be seen to be adding value. So the 'thinking' inside this treasury has really been from an 'accounting' viewpoint where transactions required by these operations are provided by treasury without any deep thought about where things are going. This is similar to how a bank might approach a client, wanting to sell transactions without working out how they might add value. In the banking sector, the debate has now moved in this positive direction and treasurers now expect such a debate with their banks. However, the first thing to worry about here is assessing those services now actually offered by the treasury.

This treasury is clearly quite advanced technologically but apart from intercompany netting there is no attempt to measure the contribution from treasury in purely financial terms and therefore the treasury is currently assessed as a cost centre. However, it is clearly gaining benefit for the group and probably quite significant benefit and so it would be best to categorise this as a value added treasury. It does not trade on its own account and does not charge margins on intercompany loans and cannot therefore be a profit centre. But it clearly has made significant investments in, for example, an inter company netting system and a trade finance delivery system and will have justified that investment on the grounds of savings, or value added. Similarly, to manage the inter company funding situation using a complex zero balancing system has required investment in treasury systems which can post statements to the web. The treasury is acting as an In House Bank.

The measurement of success in this treasury can be tackled from two directions. Firstly, it can be done from the direction of analysing the savings made by using this structure. Secondly it can be done from the viewpoint of the management of the processes in place to support the structure.

The savings treasury generates for the group include:

- Better FX pricing by dealing through trading portals and possibly aggregating deals, certainly when it comes to intercompany netting.
- Better use of cash so that cash deposited locally may be aggregated to achieve better rates, or better still, applied against borrowings.
- Administrative savings by centralising trade finance issuance into one place and having a centre of excellence for such a complex area.

***The measurement of savings***

It is very difficult to measure contribution as to what savings are being made overall to the group and contributing to shareholder value. To show savings requires a baseline (perhaps a benchmark) of what life would be like without a central treasury.

| **Service** | **Life without a treasury** | **Measurement** | **Difficulty** |
|---|---|---|---|
| FX Execution | Units would be doing deals locally, without price competition and using up resources to manage confirmation and settlement. | Difficult to calculate local rates, perhaps on the basis of percentage of prices and volumes. Also need to generate a local cost of control, admin, settlement etc. | It will be hard to persuade management of benefits on basis of estimated rates. Administrative savings, enhanced control and availability of central know-how could be persuasive factors, however. |
| Intercompany funding | Local units would borrow and deposit locally. | It is possible to compare this on the basis of local deposit rates (which could be low for small amounts) and local borrowing rates, which may be under guarantee – for which there would be a charge. | There would always be some intercompany funding, even without a treasury and so establishing a baseline becomes very difficult. It might be easy when a cash concentration arrangement is first established but this quickly becomes absorbed in history. |
| Intercompany netting | Local units would pay individual amounts, with payment costs and large FX spreads. | The contribution is easy to measure here as it falls out of the results. Less easy is the amount saved on payment costs and float, but these can be estimated. | Inter co netting is probably the easiest to demonstrate in value terms. |
| Trade finance | Local units would use local facilities, if available. It is likely that credit issues mean that | The contribution is very difficult to measure, and could be based on rates available locally. In fact central control and | There would always be some centralised trade finance issuance even without a treasury and so establishing a baseline |

| Service | Life without a treasury | Measurement | Difficulty |
|---|---|---|---|
| | no local facilities are available | knowledge of outstandings is probably the greatest benefit, which being non financial, is very difficult to measure.<br>If these instruments are only available centrally because of credit issues, then this activity isn't really about contribution, but survival | becomes very difficult. It might be easy when a subsidiary is first included in arrangements but this quickly becomes absorbed in history. |

Because rate setting (i.e. transfer pricing) may be driven by a combination of tax influence and arms length pricing, it is difficult to really calculate the benefits of this In House Bank. If the above calculations are done, the savings are likely to be substantial and then the question must be asked, is this as large as it could be? The challenge for treasury would then be to improve savings and so the treasurer needs to address the question – How can I do that? This is where process measurement might help.

***The measurement of process***

Processes can be measured relatively easily and improvements can be truly motivating to all staff concerned.

Measures common across all services (or most services):

| Measure | Possible KPI? |
|---|---|
| Speed of response to operating units | Yes |
| Customer penetration | Yes |
| Customer satisfaction | Yes |
| Exceptions outstanding in process, e.g. confirmation, bank reconciling items | Yes |
| Penalty charges | Yes |
| Time spent on processes | Yes |
| Web reports up on timely basis | Yes |
| Level of automation | Maybe |

Measures particular to one service:

| Service | Possible measures | Possible KPI? |
|---|---|---|
| **FX Execution** | Savings by competition of pricing | Maybe but difficult and probably inefficient |
| **Intercompany funding** | Interest charges in pooling mechanisms | Possibly for operating units |
| **Inter co netting** | Netting income | Yes |

| | | |
|---|---|---|
| | Tightness of timetable | Maybe – but all operating units would have to agree |
| **Trade finance** | Expired guarantees not returned | Yes |
| | Speed of issuance | Yes |

It can be seen that measurement and the setting of KPIs is not an easy task but worthwhile as a way of demonstrating both improvement and control.

Let's now think beyond these measures into the 'accounting' thinking and see how else we might measure the treasury. In other words, where should this treasury be going and how will management measure this journey.

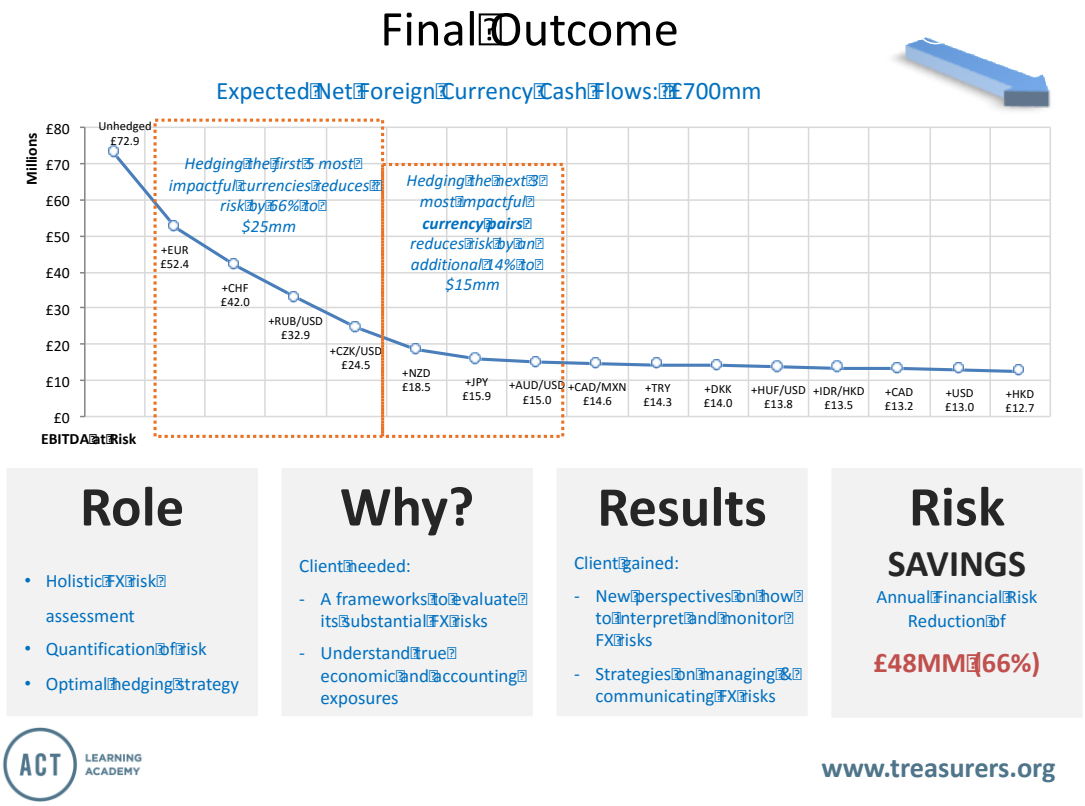
An 'economic' approach will really start to prioritise where to focus the scarce resources of treasury. One way to do this might be to look at the financial strategy within each of the business divisions, with a focus on risk. Let's take one example. One division has established a subsidiary in India where software is written. This is because well-educated labour is cheap in India, so the business model is to simply to invoice out of India into France for the wages and other costs. Treasury simply provides funding and transaction services. Treasury needs to sit down with divisional management and discuss matters such as the long term implications of including in its supply chain a high interest rate jurisdiction, volatile currency, FX control, corruption potential, tax uncertainty and issues over the location of long term value. The risks need to be measured here in some way and treasury is well placed to tackle at least some of these.

This approach takes our treasury here from stage 2 to stage 3.

| | Stage 1 | Stage 2 | Stage 3 | Stage 4 |
|---|---|---|---|---|
| **Operational** | Information processor | Data flow manager | Business partner | Change agent |
| **Primary focus** | Transaction flows | Policy and procedures | Concept introduction | Value added initiatives |
| **Success measure** | Transaction settlement | Timely & costs effective execution | Supporting company / business objectives | Driver of shareholder value |
| **Key challenge** | Volume | Bureaucracy | Acceptance | Leadership |

A 'probabilistic' approach in thinking will move the treasury further away from transactions and into risk management and start to consider how the underlying economic risks might move together and affect the company as a whole. Here, we need to see the treasury gathering all risks together to see how they intertwine and correlate, remembering that diversification is a key element of investment. Here we can see that treasury will start to move to stage 4 and drive shareholder value with its assessment of the risks affecting Sysventure. Treasury here needs to be measured by its ability to collect information, and then analyse and assess it.

Finally, the ‘portfolio’ approach in thinking will take the probabilistic approach one step further and implement risk management solutions on the back of it. In this approach, models are built and the key elements of risk are identified to see where the biggest risk arises and where risk products can be applied to best effect. It might be found that risk can be reduced by 80% with 20% of exposure hedged. An example of this approach used by one consultancy firm is shown below. Alternatively, it might be appropriate to use out of the money options to hedge one particular risk. In these cases, the transaction services currently offered by the Sysventure treasury are scaled back to a more ‘spot trading’ type approach because many of the long dated exposures are managed by portfolio. Treasury here needs to be measured by its ability to measure risk and reduce it.




Conclusion

We have seen how the treasury at Sysventure is tackling current problems and offering good value services and should be measured on this. However, it could also be argued that it is really only in an early stage of development and could be doing much more to support the business as a whole. The treasurer needs to be challenged on this and therefore measured. Of course, he probably finds it hard enough to find the time to offer the services he does and by the time he has looked at adding value as we have suggested, something comes along and takes him away from this task. However, we do need aspiration.