



The Guide to

Treasury & Cash Management

in Latin America

A SUPPLEMENT TO

LATINFINANCE[®]

Reality Check: Centralizing Latin Treasuries

by Susan A. Hillman, Partner, Treasury Alliance Group

Centralization is an often-used buzzword in treasury circles these days. For corporations operating internationally, the concept has become a reality – in Europe. Across that wide geographic region and multiple banking systems, it is possible to manage cash, liquidity and risk on a daily basis, and in many cases using a single banking platform. Much of this has been driven by the move to the euro and by companies utilizing enterprise resource planning (ERP) business applications platforms; centralizing manufacturing, distribution and service operations; and focusing on cost reductions. Also, many large global banks have developed efficient platforms for servicing the entire region.

Having been successful with the European treasury model, many companies are looking to implement these same changes in other areas of the globe, including Latin America. But can companies successfully centralize treasury operations in this vast geographic, multicultural and commercially challenging region? The prospects for

centralization in Latin America are limited at best.

This is not to say that such attempts should be ignored or given up as hopeless from a treasury management perspective. But to attempt to duplicate a European-type model in Latin America is neither feasible nor realistic, because of three main barriers: tax, regulatory and banking.

Bricks and Mortar

Viewed geographically, Latin America is immense, beginning just south of the US border in Mexico, covering the Caribbean, Central America and reaching to the tip of Argentina, which is a stone's throw from Antarctica. However, from a business perspective, the corporate bricks-and-mortar commitment to Latin America is relatively limited in comparison to Europe. Because of the currency risk, many businesses will only export goods to Latin America, and they will receive payment in dollars. Indeed, the trade currency for most of Central America is the dollar. Often, domestic business in local currency is handled through local distributors.

Establishing a physical presence for manufacturing, service or sales tends to occur mostly in larger markets such as Mexico, Brazil, Argentina, and to a lesser extent in Venezuela, Chile, Colombia and Peru. Those are the main countries where a foreign-owned enterprise may have a physical presence, and it is only then that cash and liquidity management become an issue.

Even if a company's actual cash exposure in Latin America is limited to a handful of countries, the complexity of dealing with the region's various political and economic environments cannot be understated. In most Latin American countries, fundamental weaknesses in the currency result in a constant threat of devaluation; high local interest rates and inflation; limited availability of local currency funding; fewer hedging instruments; and punitive restrictions invoked during periodic crises, such as the current situation in Venezuela. In many cases, the cost of hedging may be higher than the likely devaluation cost, which exacerbates the fundamental financial risk.

These currency problems, coupled with a strict regulatory environment in many countries and less efficient banking systems than those found in Europe, further erode

contents

WORKING CAPITAL	page 5
BANKS	page 9
EUROPAYMENTS	page 13
CASH MANAGEMENT	page 15
RISK MANAGEMENT	page 18

Associate publisher: **James Norton**

Tel: 305 357-4227

e-mail: jnorton@latinfinance.com

Project manager: **Leslie Hillman**

LatinFinance Guides are partially underwritten by sponsors and reflect the views of the individual contributors and/or their institutions.

treasury & cash management intro

the possibility of a centralized treasury approach. Brazil and Mexico, however, are notable exceptions as companies there have access to more developed electronic banking services.

Managing Liquidity

The cornerstone of effective liquidity management is to maximize the use of internal cash. The parent or certain cash-rich subsidiaries finance sister entities that are in need of cash through inter-company borrowing arrangements, or short-term banking solutions such as cash pooling. In Latin America, however, due to foreign exchange regulations, capital restrictions and withholding tax, it is virtually impossible to manage liquidity regionwide on a daily basis.

Moving funds in and out of a country is either severely restricted, fairly limited, somewhat complicated or too expensive. Depending on the country, it may be possible to freely remit dividends and payments abroad without having to pay a withholding tax. However, interest payments on loans from related companies, such as a sister or a parent, are taxed at the standard local income tax rate, which can range from 15% to higher than 30%. But borrowing from a financial institution, located either inside or outside the country, is usually taxed at a significantly lower rate. So although it is cost-prohibitive to set up a direct inter-company offsetting/lending arrangement, many companies use a third-party bank as an intermediary.

The best approach for multinationals trying to manage liquidity and risk in Latin America is to work at the country level to match local receipts and payments to the greatest extent possible without moving money in or out of the country. In other words, this means improving the

company's working capital. To accomplish this, companies need local cash management expertise in the subsidiaries and not just at central headquarters. However, if additional cash is required to fund local operations, companies can consider short-term capital injections, as long as it is possible to repatriate the funds later through dividends or inter-company payments.

This technique is extremely effective in Brazil and has minimal negative implications from an accounting, cost or tax perspective. On an administrative basis it can be more cumbersome because such capital must be registered with the Central Bank. Registration simplifies the repatriation of the funds later. With a Brazilian subsidiary, parent companies may register capital on an annual basis and send the funds incrementally throughout the year. Filing annually helps companies avoid the paperwork and documentation that is required each time a new capital injection application is made.

Once the funds are sent into Brazil as capital, they are immediately converted into local currency and frozen at the foreign exchange rate at the time of remittance. They will remain so in the subsidiary's financial statements until they are repatriated. Another liquidity management technique that is used successfully in Latin America is that of establishing a Sociedad Anónima Financiera de Inversión (SAFI). This corporate structure, available in Uruguay, requires registration and a physical presence or agent representation in Uruguay, and it only applies to US dollars. It is a tax-free center. However, because of the country's treaty arrangements and other factors, this tax-free center is not considered a tax haven. Using a SAFI holds little appeal for most multinationals because often their excess cash is used to pay inter-company invoices, remitted as a dividend or transferred to another non-US corporate financial center for tax purposes.

Common Treasury Abbreviations

ACH	Automated clearing house
ASP	Application service provider
EFT	Electronic funds transfer
ERP	Enterprise resource planning
CB	Central Bank
FX	Foreign exchange
LC	Letter of credit
RTGS	Real time gross settlement
SAFI	Sociedad Anónima Financiera de Inversión
SEPA	Single Euro Payments Area
SSC	Shared service center
STP	Straight-through processing
SWIFT	Society for Worldwide International Financial Telecommunication
VAN	Value-added network
ZBA	Zero-balance account

Banking Systems

In most Latin American countries, the banking system is dominated by a handful of large indigenous institutions. The development of efficient payment infrastructures, electronic clearing houses and real time gross settlement (RTGS) systems has been slower than in European countries, due to both economic and geographic reasons. The notable exception is Brazil, long renowned for its banking efficiency.

During the 1970s, large Brazilian banks led by Banco Bradesco worked to link far-flung branches electronically and to provide timely clearing of checks. As a result, clearing zones throughout the country became completely integrated and checks clear nationwide on an overnight basis. Today, checks have been almost entirely replaced by electronic payments. Most companies pay for goods using some type of paper or electronic form issued by the company selling the goods or by the seller's bank. The buyer uses the form to pay at any bank in the country. The bar-encoded form is processed through the clearing system

Highlights by Country

Brazil

- Excellent and efficient banking system
- Working capital management is an art form

Argentina

- Inefficient banking and clearing system even before 2001 crisis
- Collections are a real problem, especially in the interior

Venezuela

- High degree of risk even prior to Chávez regime
- Almost impossible to keep minimal inventories as supplies are so essential

Colombia

- Some banking system improvements
- Collections in rebel-held areas are extremely difficult and dangerous

Central America

- Extremely inefficient banking systems, slow clearing and high float
- Costa Rica is an exception

and credits the money to the seller's bank account.

Mexico also has a highly developed banking system, although this has come about more recently than in Brazil. Mexico's largest banks have had internal electronic networks for almost 20 years, but there was no nationwide integrated RTGS or automated clearing house (ACH) platform there until a few years ago. Since then, Mexico has rapidly moved from a cash and check dominated environment to a highly electronic banking system. This was not only the result of technological improvements; it also came about because of currency devaluation, risk and fraud in Mexico, which forced multinational banks, companies and individuals to move to a more secure and efficient method for trade and settlement.

In most other Latin American countries, manual clearing between banks and regional clearing houses is gradually being upgraded to electronic systems. Nationwide RTGS systems are set up initially to clear large-value transactions between banks and to handle securities trading. However, the RTGS system requires greater amounts of collateral to be maintained with the central bank than is necessary in local net settlement systems. These issues, as well as the economic and political volatility seen in Latin American countries – Venezuela being the current notable example – can definitely hamper the rate of progress of these system upgrades.

The development of ACH systems to handle lower-value payments has been even slower than that of RTGS

implementation for large-value payments. Delays in ACH development in Latin America often stem from local dominant banks seeking to control the upgrades to ensure they do not lose market share in the process. In most countries, intensified competition between the top banks requires them to cooperate amongst themselves to reform processing methodologies and introduce nationwide compatible technology. But in Venezuela, Colombia and Argentina and elsewhere in Latin America, it has been difficult to obtain a consensus between the major banks as to how to proceed or who should participate in the initial phases of development.

Consolidation

Multinationals are also striving to use a single bank throughout the region. Citi, BankBoston, ABN AMRO, ING, HSBC, Santander Group and BBVA have a strong historic presence and often a wide branch representation in certain key countries. However, this does not translate into regional banking or centralized liquidity overlay solutions similar to those offered in Europe, for all of the reasons discussed above.

A handful of these banks do offer standardized electronic services, such as batch-payment systems that allow companies to pay all vendors from one central location. However, these services generally are only cost effective for the very largest multinationals, or those with significant vendor payments that might entail millions of dollars and hundreds of transactions per month in the region. Being able to utilize these standardized services is also highly dependent on the level of efficiencies or deficiencies in the local banking system, a country's regulations and the existence of ACH or privately owned value-added networks for the transmission of data. All of that said, partnering with a bank that has a history, a network in the region and a single banking platform can be an effective way of maximizing any potential cash management techniques and services multinationals may want to use.

A Central Treasury

Realistically, it is virtually impossible to sit in a central location – be it Chicago, Miami, Mexico City or São Paulo – and manage cash on a daily basis into, out of or around Latin America. The collection of funds can be fraught with problems, cash management practices, vary from country, and banking-system capabilities vary widely.

But having said this, there are certain things that

Treasury Alliance Group

Susan A. Hillman, Partner

Phone: +(1) 847 295-6414

Email: sahillman@treasuryalliance.com

Website: www.treasuryalliance.com

treasury & cash management intro

Treasury Pitfalls

These are some common trouble areas for Latin American treasurers to watch out for:

- Undercapitalizing subsidiaries
- Weak staffing at local finance level
- Lack of contingency planning
- Paralysis by analysis and lags in decision making
- Limited understanding from headquarters of local politics and commercial practices

companies can do to manage liquidity in the region. As a start, a company should designate a particular subsidiary, center or individual – even someone located at corporate headquarters – to oversee financial and banking activities and liaise with local subsidiary financial controllers and cash managers in each country.

This central treasury would ascertain whether all subsidiaries are managing cash as efficiently as possible given the limitations or opportunities in each country. A focus on improving credit and collections, implementing automated cash concentration and using batch electronic payments where possible is key. The group should outline and oversee the implementation of best practices for treasury management in each country and it should institute a standardized system for measuring and evaluating each of the subsidiaries. Fostering the exchange of information about banking services and treasury procedures between Latin American subsidiaries is also useful, because it insures common procedural and philosophical standards in each country.

A central treasury should arrange and oversee the overall financing each country subsidiary receives. This would include all financing, including any short-term borrowing arrangements with banks, interest rate negotiations or other agreements. A central treasury would establish a core group of regional banks and then supplement that with a few strong indigenous institutions that have important relationships with the local subsidiary. Negotiating local bank pricing for services – although remaining a responsibility of the local subsidiary – can also be guided by a central treasury. For international transactions such as cross-border transfers, standard pricing is possible if the same bank is used throughout the region.

Risk Management

Multinationals can centralize their currency risk management, although this activity will likely entail the use of debt/equity arrangements, swaps, back-to-back loans and other such tools, rather than using forwards or options to hedge risk. The central treasury should make all decisions regarding these techniques. This requires close attention to political and economic news coming from the region and constant updates based on local subsidiary insights. Often, a true understanding of the potential for significant financial developments such as a currency devaluation is only available at the local country level.

Using short-term forecasts, such as those where cash flows and liquidity are estimated on a weekly, quarterly or monthly basis, and setting target cash or debt levels for each of the subsidiaries, are other essential tools for overseeing regional liquidity.

There are a limited number of very large companies that have implemented or that are moving to a centralized regional payment system. This is an onerous undertaking from an internal perspective as it requires significant systems resources and a common accounting platform across the subsidiaries. That means companies need to carry out internal systems upgrades and standardize their procedures before a regional payment program can be installed. Also, in most cases, there will still be local check or transfer payments.

Even though there may be trade between Latin American countries, it is difficult to establish centralized regional manufacturing or distribution points in Latin America. This is not only because of regulatory barriers and trade tariffs, but it is also because of shortcomings in logistics and transportation across the region. Remember, the centralization of manufacturing and distribution has been the biggest factor driving companies' centralization of payments in Europe.

Conclusions

For all of these reasons, multinationals in Latin America are unlikely to be able to duplicate the centralized treasury approach they have established in Europe.

Improved efficiency in Latin American treasury operations will not be achieved by designating a sole regional bank or adopting standardized banking services. Rather, the most success will be gained from an internal corporate emphasis on effective local cash and working capital management and a focus on managing debt/equity ratios through tactical capital injections and realistic short-term financing strategies. ■

For the complete guide please visit www.latinfinance.com