Multilateral Netting:
A Global Treasury Essential

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Treasury Goals

- Cash Management
  - Integrate local cash pools and non pooled accounts in one global structure
  - Ensure cash visibility of group liquidity with banks
  - Optimize the use of funds within the group
  - Ensure effective payment processes for group companies, both inter-company and third party
- Financing
  - Simplify and standardize inter-company financing procedures
  - Consolidate bank borrowing under prime terms negotiated with key relationship banks
- Foreign Exchange
  - Simplify and centralize FX processing
  - Consolidate and manage FX exposures

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Change Drivers

- Control
  - Sarbanes Oxley compliance
  - Security and fraud prevention
  - Counterparty risk
- Efficiency
  - Centralization and outsourcing
  - ERP integration
  - Automation and straight through processing
- Costs
  - Reduce bank costs, minimize FX volumes and transaction fees
  - Reduce supplier costs through rationalization and economies of scale
  - Reduce internal costs by concentrating expertise and outsourcing low value tasks

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Agenda

- Multilateral Netting Fundamentals
  - What it is
  - How it works
  - Who can participate
  - Practical issues and challenges
- Implementing Multilateral Netting
  - Software
  - Netting service
- Best Practices
- Case Studies and Demonstration

Multilateral Netting Fundamentals

What is Netting

- Multilateral netting is a process that simplifies and reduces the cost of settling inter-company transactions. Netting can also be used to settle 3rd party transactions.
- Netting:
  - Consolidates and off-sets payables against receivables between multiple group companies on a global and multi currency basis
  - Reduces the number of inter-company funds transfer payments
  - Minimizes costs of associated foreign exchange
  - Avoids the need for group companies to make multiple payment transfers and execute conflicting foreign exchange transactions

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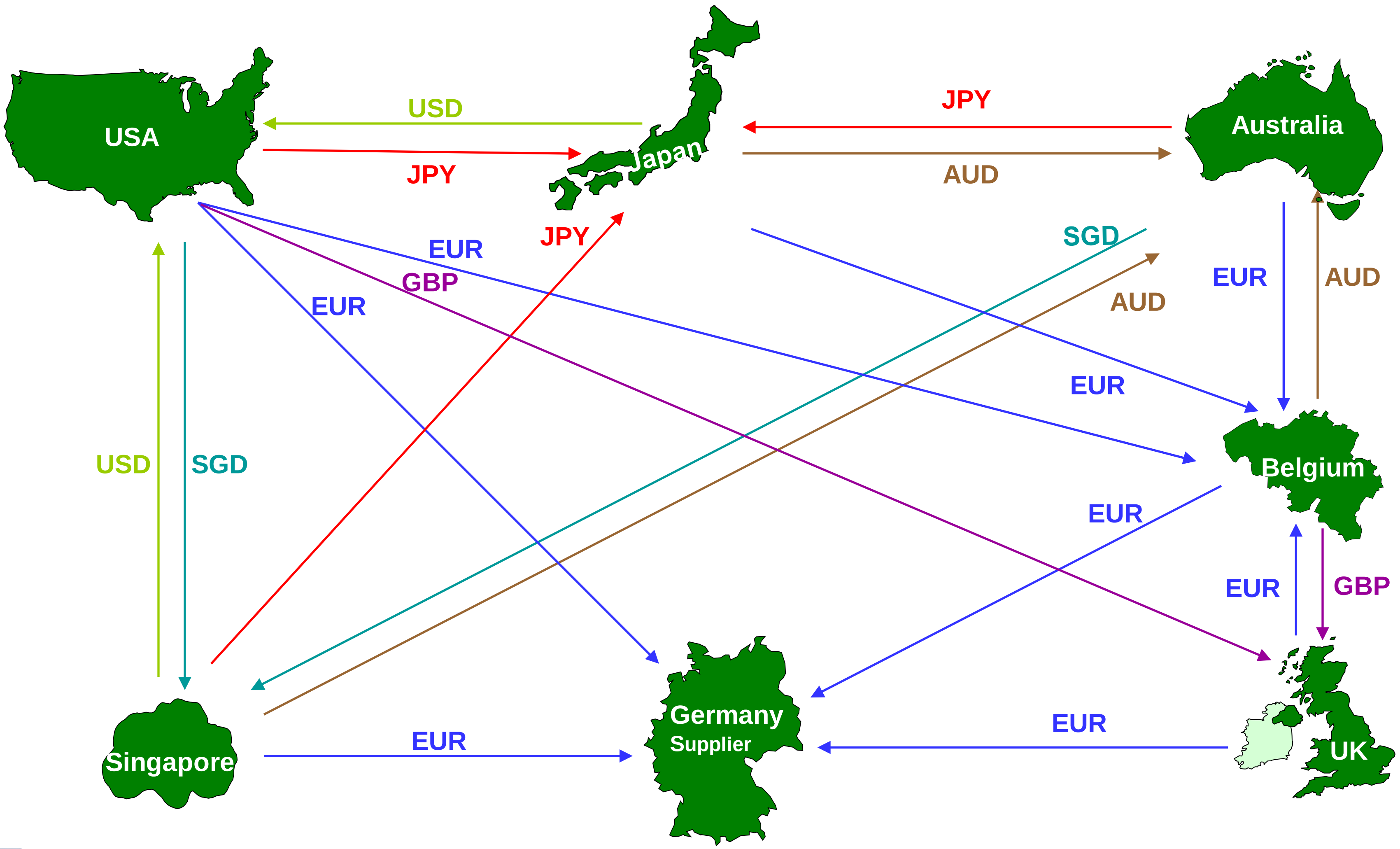
Flows Without Netting



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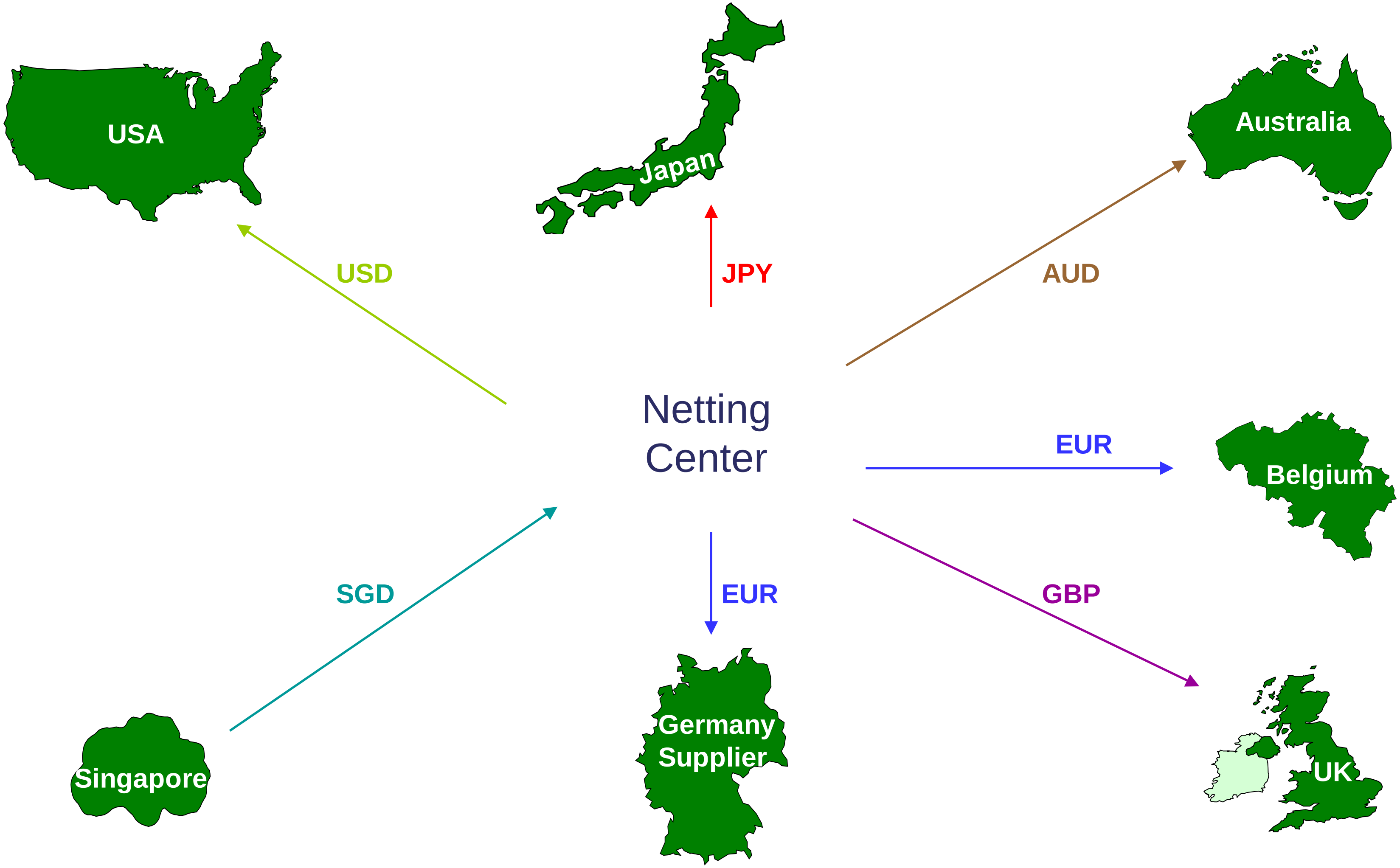
Flows With Netting



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Who Participates

- Any group entity willing to participate in the settlement of its obligations with other participants via a centralized payment system
- Selected third party suppliers; for payables only
- Subject to exchange control restrictions:
  - Some countries allow netting of payments but not in the local currency, e.g. Malaysia, Brazil, South Korea and Chile
  - Some countries forbid netting (payment offset) but allow companies to participate on a gross in/ gross out basis, e.g. Russia
  - India permits netting and allows the local company to be paid in INR for a net receivables position but net payable positions must be paid in a foreign currency
  - Some countries require central bank approval before netting payments can be made
  - China allows netting on a gross basis, subject to approval by SAFE, but not in local currency

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Payables vs. Receivables

- Zero sum game: intercompany receivables = intercompany payables
- Netting systems can be receivables driven or payables driven
- Receivables driven offers cleaner/ faster administration and reconciliation and is better for funding manufacturing / supplier entities within group, allows payment "leading"
- Payables driven is more common and acceptable to payers and is better for funding sales entities within group, allows payment "lagging"
- Can work at individual line item level or at an invoice level

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More Than Trade Payables

- Multilateral netting can handle the following inter-company transactions:
  - Trade payments
  - Interest payments
  - Royalties
  - Dividends
  - Internal / external hedge contracts
  - Service-fees
  - Management fees
  - Loan repayments
  - Investments
- In addition, participants can “offer” surplus cash or “request” for it within the netting
- Netting isn’t just for inter-company transactions; third party supplier payments can be settled too

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How It Works

STEP 1: Data collection

- Collect the invoice details from affiliates
  - Spreadsheets
  - Inter-active input
  - File upload from ERP system
  - Allow for additions/deletions/amendments

STEP 2: Netting calculation

- Calculation process to determine net position for each participant
  - Trial run using “estimated” FX rates to determine “net currency positions” to be traded
  - Second run using “actual” FX rates

STEP 3: Settlement

- Settlement process;
  - Net “payers” pay netting center for value “settlement day” in local currency
  - Netting center pays net “receivers” in their local currency
  - Netting center settles FX trades with 3rd party banks for net position of each currency.

Notes:

- Participants do not need foreign currency accounts
- Netting center should be left with a ZERO position on all currencies

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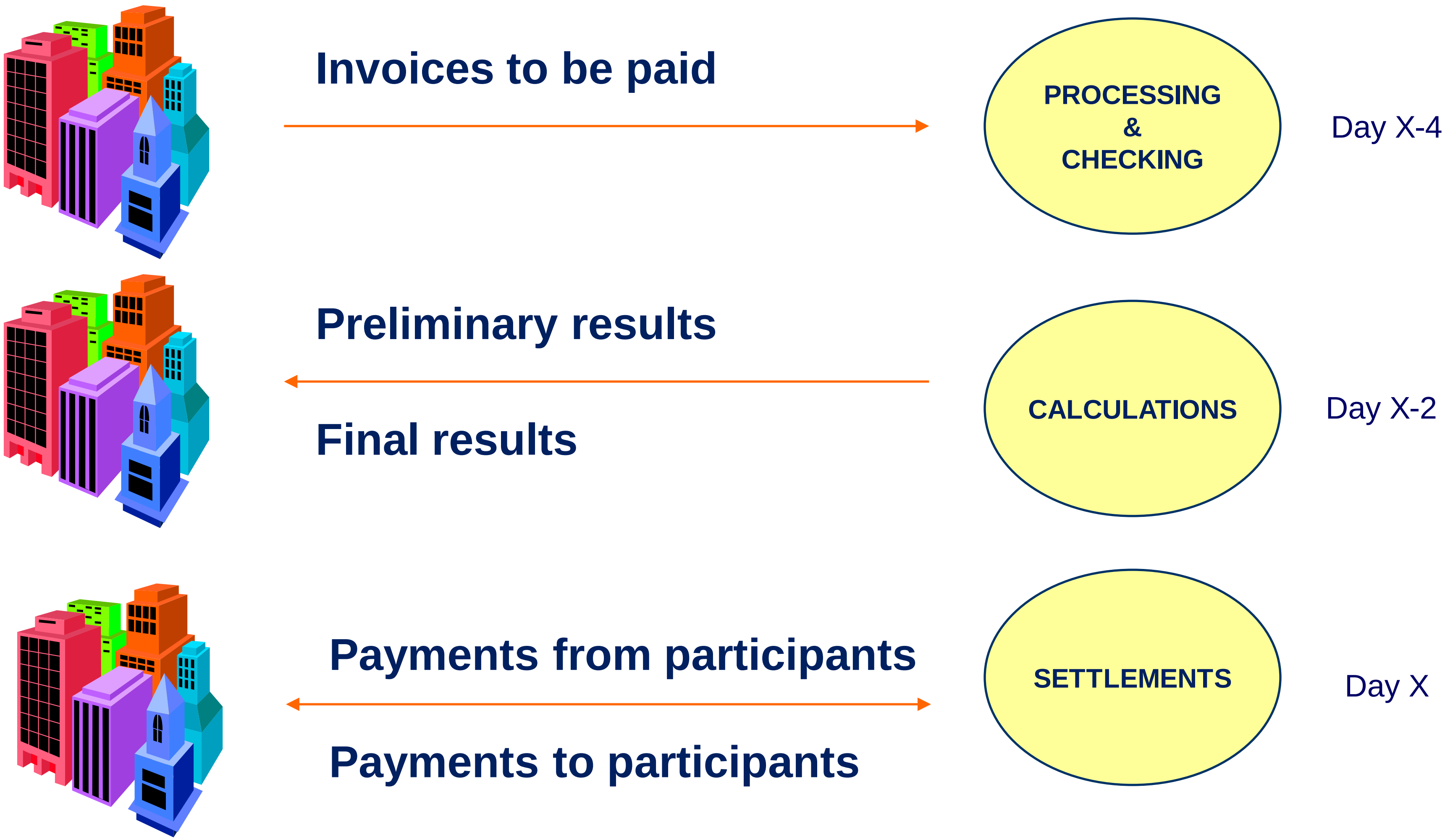
The Netting cycle



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Netting Cycle 1

Date X - 4: Input deadline

- Participants advise NETTING CENTER of transactions to be paid on value date X

Date X - 3: Preliminary netting run

- Netting center runs a preliminary netting, using “estimated” FX rates.
- Each participant is advised of estimated net outcome including details of:
  - Gross payable and receivable balances totaled per payee/payer and per currency.
  - net payment or receipt to expect
  - settlement instructions
- Each participant should reconcile the preliminary advice with the intercompany open-item file.
  - Any discrepancy should be resolved between payers/ payees not by the netting center
- Participants may change/add/delete input

Date X - 2: Netting day

- Netting center obtains market rates from banks for FX deals to be transacted
- Netting center runs final netting using market rates
- Netting center completes FX trades for net currency positions
- Netting center advises each participant of final net amount to be paid and correct settlement instructions

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Netting Cycle 2

Date X – 1 : Issue Payment Instructions

- Netting Center issues payment instructions to Bank to settle FX contracts and to pay net receivers for value X
- Net “payers” instruct their banks to pay the netting center on value date X.
- Alternatively, the Netting Center may issue multi-bank SWIFT MT101 messages through its bank to “drawdown” funds due from net payers.
- Net payment/ receipt flows for participants will be in local currency (exchange controls permitting) and will be made through existing accounts held with their local banks.

Date X : Settlement day

- All payments settle
- Netting center payments and receipts should “wash”
- Netting center reconciles and investigates any discrepancies

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Benefits

- Efficiency
  - Fewer cash flows and improved predictability of remaining flows
  - Provides mechanism for inter-company borrowing
  - Reduces intercompany balances on the balance sheet
  - Introduces standardization and discipline into inter-company payment procedures
  - Improves the intercompany reconciliation processes
  - Reduces the need for non-functional currency accounts
- Financing
  - Allows for inter-company financing through “offer” process
  - Allows “leading and lagging”
- Risk management
  - Centralizes FX management at netting center
  - Reduces the number of FX transactions and improves FX spreads
  - Provides stronger audit trails of payments sent / received
- Cost
  - All of the above favorably impact cost – which is a good thing

Issues and Challenges

- Participation: voluntary or mandatory?
- 3rd party supplier participation
  - how to get it?
- Data collection responsibility
  - who to do it?
- Data collection process
  - how to do it?
- FX exposure management
  - netting doesn't change exposures
- Timely payment from participants
  - Late payments can cause overdrafts and interest claims
- Bank fees on payment transfers
  - cause annoying discrepancies
- National bank holidays
  - avoid when creating netting calendar

Implementing Multilateral Netting

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In-House System

- How it works
  - Netting (Treasury) center utilizes netting module of treasury management system, or in-house developed system
  - Preferably with internet file download/upload
  - Requires treasury center to own set of currency accounts
  - FX bank independent – can use a panel
- Issues
  - Systems maintenance
  - Back-up for systems downtime and staff vacations
- Pros and Cons
  - Sometimes only bilateral and balance based
  - Competitive FX bids ensures best rates
  - Greater flexibility/ use of discretion in serving participants
  - Executing netting settlements with proper value date and problem follow up can be labor intensive

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Third Party Application

- How it works
  - Netting center and all participants use same on-line application for calculations and communications
  - Requires center to own set of currency accounts to pay/ receive
  - FX bank independent – can use a panel
- Issues
  - Netting center becomes the “end user” rather than controller of the process
- Pros and Cons
  - Removes responsibility for systems maintenance problems
  - Retains ability to obtain competitive FX bids
  - Software fees increase with number of participants

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Managed Service

- How it works
  - Netting Center function is outsourced completely
  - Participants deal directly with outsourcer
  - Outsourcer owns currency accounts – not treasury
  - Outsourcer executes payment instructions
- Issues
  - Company appetite for outsourcing
- Pros and Cons
  - Faster implementation
  - Problem follow up done by outsourcer
  - Guaranteed that funds will be paid / collected with proper value date
  - FX costs cannot be eliminated entirely, outsourcer trades remaining FX; lose ability to obtain competitive FX bids

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Best Practices

- Payables or receivables driven?
  - Payables is more common; permits participants to exclude invoices
- File upload is preferred data capture method
  - Best done by a shared service center
- Align with inter-company payment terms
  - Example: upload payables which are due in 30 days
- Accounting has stake in the reconciliation process
  - Matching netting output with open invoices
- Most groups operate with 1 monthly netting
  - Plus additional bi-weekly or weekly runs for third parties
- Implement in phases
  - Build up experience
  - Execute test run before going live

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Questions and Certification

To obtain a certificate of completion for CPE or other financial certification please email CPE@treasuryalliance.com

A copy of the Webinar slides and a recording of the Webinar will be on www.treasuryalliance.com in the resources tab

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