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
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
• 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
Flows Without Netting

USA

JPY USD

Japan

EUR AUD

Australia

GBP SGD

Belgium

EUR AUD

Singapore

USD SGD

Germany Supplier

EUR

UK

EUR GBP
Flows With Netting

Netting Center

- USA
- Japan
- Australia
- Singapore
- Germany Supplier
- Belgium
- UK

Currencies:
- USD
- JPY
- AUD
- SGD
- EUR
- GBP

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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
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
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
How It Works

STEP 1: Data collection
• Collect the invoice details from affiliates
  - Spreadsheets
  - Interactive 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
The Netting cycle

Invoices to be paid

PROCESSING & CHECKING
Day X-4

Preliminary results

CALCULATIONS
Day X-2

Final results

SETTLEMENTS
Day X

Payments from participants

Payments to participants
**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
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
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
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
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
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
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
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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