

New Directions in Multilateral Netting

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October 1997

It's true that you can run a small netting operation using a carefully crafted spreadsheet. After all, netting isn't rocket science, just a simple matter of converting intercompany payables into each Participant's base currency for a single net position settlement. But as multilateral netting evolves in response to new challenges and needs in the modern global treasury center, many companies are beginning to use netting systems in ways unimaginable just a few years ago.

The classic netting model that evolved in the late 70's was very straightforward: Participants fed in information on their payables to other Participants on a monthly basis. The Netting Center then calculated the net position for each Participant, traded the residual currency positions and handled the net cashflows to and from Participants. Companies often found it convenient to partially or completely outsource the whole process to a bank that could provide the telecommunications and currency-trading infrastructure. This remains the way some companies - particularly those new to netting - start off, as it is relatively easy to implement and it achieves the core need of netting cashflows in return for a monthly fee.

The next spin on netting arrived late in the 80's with improved corporate telecommunications and FX trading capabilities. Companies found they could take on the whole process using corporate e-mail networks to receive netting data from Participants. By that time, many companies were more comfortable executing the FX trades at the end of the netting cycle themselves, in order to improve on the netting exchange rates they were achieving. To the savvy, there were no more monthly processing fees.

A comprehensive approach

As we approach the millennium, however, neither of these two models seems to provide an adequate netting solution for many organizations. Indeed, corporate treasuries today have greater needs than simply netting out what is essentially a snapshot of intercompany cashflows once a month. Instead, the more sophisticated users are now using their netting systems as an integral component of a comprehensive exposure and multicurrency cash management system.

Perhaps the Belgian Coordination Centers (BCC's) where many of the world's netting systems reside, are still the best exponents of efficient integrated netting. In most BCCs, netting (or 'clearing' as most BCC's view netting - the name itself demonstrates its function) is just one small piece of a system that administers outstanding cashflows projected forward over several months, currency hedges for significant forecasted cashflows, and an intercompany lending operation that efficiently pools cash across multiple currencies. Often, just two or three people manage this in-house banking process.

The role of netting as a component of a comprehensive risk and cash management system raises new issues in modeling an efficient system. For users to get maximum benefit, their netting operations must work integrally with other risk management and cash management

applications, hence a standalone, entirely outsourced and proprietary system may no longer do the job.

A modern checklist

Here are some ideas on how the current trends in netting could be used to provide a more efficient and integrated piece of a similar regional or global in-house treasury management function:

1. Avoid the subjectivity of remote entry. Let's face it: Participants don't enjoy preparing yet another set of data to report to Head Office each month, regardless of how the data is prepared, where it is sent and by what means. In a typical payables-based netting system, there is very often some room for the Payer to decide what gets placed into the netting system, and what is reported. The result is inefficient netting and quite possibly currency exposures that are not correctly identified and managed.

With the advent of global GL systems and data warehouses, many companies are now switching their data source to a single download from one central source, disintermediating the Participant, by eliminating the need for his or her involvement prior to the actual netting. The Netting Center automatically selects all items due for payment and nets them. Once netting had been completed, that same data source can then be updated with the exchange rates used to net each item. By taking remote entry out of the picture, the netting system becomes both more efficient and more accurate.

2. Attain both precision and efficiency - a win/win situation. Balance-based netting is certainly simpler to implement because transaction volumes are much lower and therefore more easily managed. However, true invoice-level netting offers a much more structured environment for tracking and reporting the contents of the netting operation. By downloading the netting data from a central source, the burden of reporting at the invoice level is removed, and modern netting systems are now easily capable of recalculating the net on many thousands of items in just a few seconds. With the cost of number crunching radically reduced, the old tradeoff between precision and efficiency is no longer a prerequisite for treasury managers.

3. Put more cashflows through the netting. Netting doesn't have to be just for the typical intercompany invoice or transaction cashflow. Any time that a cashflow is routed through the netting instead of settled individually, there is yet more potential for cashflow and foreign exchange offset. Third party payments can easily be routed through a netting system, and can actually cut down significantly on transaction costs and foreign exchange costs if the netting system is used as a central disbursement mechanism. Using this approach, Participants' cross-border payments are replaced by in-country disbursements from the Netting Center's own accounts.

Dividends, capital payments and other miscellaneous payments are all candidates for the netting system: as an example, one company started netting (profitably) a year ago with just

three Participants and three cashflows. Less than six months later, their netting volume had grown to more than 100 balance-based cashflows plus innumerable miscellaneous cashflows.

In the spirit of further reducing foreign exchange transactions that occur outside of the treasury center's control at poorly managed exchange rates, encourage Participants to submit excess non-base currency balances through the netting for conversion, and to obtain required non-base currency amounts in the same way.

4. Hedge future netting cycles. The most significant benefit of invoice-level netting is payment scheduling. Invoices have a due date, and they can be reported into the netting database at any time and remain there until they fall due for payment. As a result, it is possible to forecast not only the current cycle's results, but also the results of future cycles allowing treasury to manage and hedge future net balances.

Hedges of anticipated balances can be implemented using several methodologies, ranging from individual hedge rates by transaction for the Payer, receiver or both parties, through to the more common practice of hedging anticipated Participant positions based either on positions forecasted from the invoice database or on separate forecasts reported by Participants. In netting systems that generate relatively consistent net results from cycle to cycle, it is also possible and sometimes desirable to hedge the entire forecasted net position by currency.

5. Leverage internal FX trading operations. In the classic netting system discussed earlier, it was normal to estimate net positions using current exchange rates, then go out and trade the net positions in the FX market and re-run the net with these final rates. However, there are other ways to generate the net results. If your Treasury Center has the luxury of a trading function that maintains its own currency positions, it is preferable to simply lay off the net currency positions to the trader, at exchange rates provided by the trader. This methodology not only avoids the task of recalculating the net with externally traded rates, but also reduces overall corporate FX trade volume.

At the extreme, companies could even consider using predetermined netting rates that may have been set well in advance, which would have the effect of laying off all currency exposure from Participants to the Treasury Center at budget rates. In this case, an efficient forecasting mechanism is obviously needed so that the Treasury Center has the opportunity to hedge positions. Plus, a risk management program, which monitors and manages the variation between actual and 'net' rates, must be put into place.

6. Mesh netting with multicurrency cash pooling. Multicurrency cash pooling is the Holy Grail of Treasury Centers! But the many permutations offered by banks may not always be really efficient. Daily multicurrency cash pooling is virtually impossible to implement without incurring substantial costs and trade-offs that impact the benefits of the process.

The answer may be to abandon any thought of a daily process, and instead set up a periodic - for example weekly - pooling process that allows for consultation between Treasury Center and Participant. Funds are drawn down from, and remitted to, Participants each period using an intercompany loan program. Standardized dating of pooling operations then permits more

effective hedging of the outstanding loan balances, and certainly much finer interest rate pricing which is a function of the Treasury Center's base currency cost of funds and the FX swap rates to each currency.

To squeeze the most efficiency out of the netting system, schedule the netting settlement date to fall on a pooling date, so that the netting results are fed into the pooling equation rather than automatically settled with Participants. This is just another way of looking at an age-old issue in netting systems: Participants sometimes don't want to settle their natural net position with the Netting Center, but instead wish to settle a target position. Some use leading and lagging techniques to prepay or delay payments in order to achieve targeted results. There's only one hitch: the target vs. net position netting tends to create unidentified currency exposures in the netting which are often somewhat arbitrary. For the sake of safety and precision, it is normally better to force-settle everything due for payment and use a loan program to juggle balances.

7. Go beyond the 'easy' currencies. Netting was born of necessity in a multiple-currency Europe and for many years netting was viewed as a somewhat 'European' practice, only gradually being extended within the past 15 years to North America and Asia. Even then, it was felt that many countries could not participate in a netting operation because of a lack of currency convertibility or because of pseudo anti-netting regulations such as those which will only this year be lifted in Japan. But that does not stop the truly global corporations which have long recognized the real purpose of a netting system. Careful selection of functional currency and book settlement instead of actual cash settlement of net positions can often go a long way to achieving desired results.

Conclusion

These trends are changing the focus of netting. The principal challenge is no longer how to collect the data and distribute the results back to Participants, but how to maximize the opportunities offered by a netting system to more efficiently manage currency exposure and multiple currency cash balances.

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