

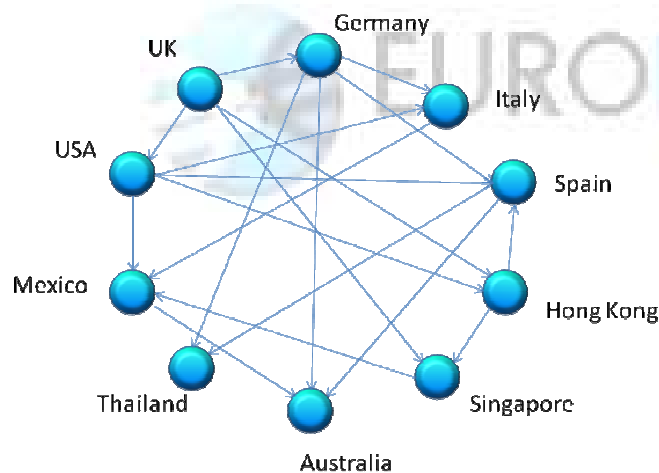
What is Multilateral Netting?

by EuroNetting Inc.

Multilateral netting is a treasury management technique used by large companies to manage their intercompany payment processes, usually involving many currencies. Correctly applied, netting can yield significant savings from reduced foreign exchange trading and improved intercompany settlement efficiency.

A netting system collates batches of cashflows between a defined set of entities, or Netting Participants, and offsets them against each other such that just a single cashflow to or from each Participant takes place to settle the net result of all cashflows. The netting process takes place on a cycle basis, typically monthly, and is managed by a central entity called the Netting Center.

Although netting systems are occasionally used to net out cashflows in just one currency, it is more usual for a netting system to manage cashflows in several currencies. In a multiple currency netting system, each Participant's cashflows are converted to an equivalent amount in the Participant's base (or functional) currency, so that the Participant still has only a single net position to settle in that currency.



BEFORE: Without netting, each entity settles its obligations directly and individually with each counterparty

The task of managing the conversions from one currency to another is the function of the netting system: it uses exchange rates supplied by the netting operator to calculate all conversions, and will generate a list of currency positions - one position per currency - that must be traded in order to purchase and sell the relevant cash positions that will be settled with each Participant. Trading takes place at the conclusion of the netting process: using a provisional list of open currency positions, the netting operator will trade each position, either against each other or more often against a selected overall base currency (for example the US Dollar), and then uses the actual traded rates to recalculate the final net position of each Participant.

To settle the net, the netting operator then pays or receives each Participant's net position to or from the Participant, and uses the resulting long or short currency balances to offset the FX trades. These cashflows are normally settled using a set of multicurrency accounts, and if all has been correctly calculated, the net currency balances will be zero after everything has settled.

Savings from netting

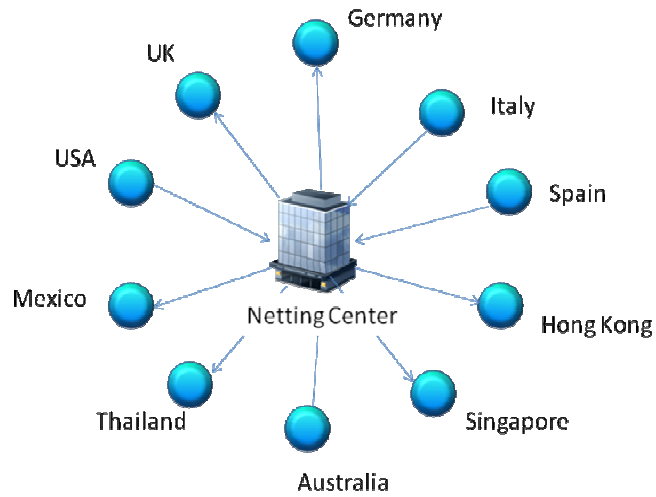
A netting system is typically used by a multinational company that has many production and sales divisions in a number of countries. Direct billing in many currencies by each Participant can lead to excessive foreign exchange trading, in which individual Participants may be both buying and selling the same currencies many times over. The objective of a netting system is to reduce the overall foreign exchange volume traded and thereby cut the amount of foreign exchange spread paid by the company to manage all the currency conversions. Trading netted currency positions centrally should also yield the benefit of better (i.e. lower) FX spreads because a more professional approach to FX trading can be employed. In a typical netting operation, it is common to cut FX volume and spread by up to 70%.

Essentially a simple process

Netting is essentially a very simple process - just a series of simple conversion calculations that could be managed using a carefully constructed spreadsheet. Moreover, the netting results generated by any netting system - whether a spreadsheet, an outsourced service or a commercial netting system - will exactly match, provided the same transaction source and netting rates are used. Indeed, a key step in converting from one system to another is to run the data in parallel for one or two cycles to confirm that the new system operates correctly.

Extending the basic netting model

Probably 50% of all netting operations worldwide do not go beyond a very simple netting process that can be managed by all netting systems - they input or import their netting transactions, set the provisional netting rates, trade the net positions, update the traded rates, recalculate the net and settle the resulting positions. But many netting operations are now using the netting system in more ways, often in connection with a central or regional treasury management function. The treasury center may be hedging forecasted cashflows and applying hedge rates to the individual cashflows being settled through the netting system, or an intercompany lending program may be operated in conjunction with the netting in order to modify Participants' net settlement positions, or the netting system may be used as a central third party disbursement mechanism even where a traditional internal netting need may not exist.



AFTER: Using a netting system, each entity pays or receives just a single local currency balance to or from the netting center

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