# Fundamentals of multilateral netting

Caroline Shuffrey reminds readers of the essential features and importance of effective multilateral netting in foreign exchange transactions.

Multilateral netting can be defined as the management of cross-border payments resulting in a net receipt or payment to each entity in their local and/or preferred currency. The process can be managed centrally using a treasury or shared service centre. Alternatively, this type of arrangement can be outsourced.

In its simplest form, multilateral netting is used to settle intercompany balances as can be seen in *Figures 1* and *2*.

### *Benefits*

The centre, rather than the individual subsidiaries, is responsible for effecting payment. As only one payment is made to/from each subsidiary in their local or preferred currency the number of transfers is reduced, lowering cross-border transfer charges. Individual subsidiaries no longer pay expensive foreign currency commissions as the net purchases and sales are effected by the centre or outsource partner. It is also possible that cross-border payments made by individual subsidiaries, through local banking arrangements, will lose value dates. This is not the case when the process is centralised using global banking arrangements. Subsidiaries find it easier to use intercompany netting arrangements rather than to arrange the foreign currency payment themselves. The group is able to track intercompany exposures effectively using a netting system.

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### *Third party payments and receipts*

Multilateral netting can also include third party payments and receipts. For example, a supplier to the group may offer a substantial discount for centralised invoicing in one currency. Each subsidiary is able to pay its portion of the invoice in local currency through the netting process. Alternatively a customer or client with a centralised payment function may put pressure on the group to receive payment centrally in one currency. The netting process can be used to ensure that the local subsidiaries receive their portion of this receipt in local currency.

### *Other features*

The netting can be executed spot or at a chosen forward date. Individual subsidiaries can forward hedge their

*FIGURE 1*

## Intercompany multilateral netting

| | | |
|---|---|---|
| *UK subsidiary owes German subsidiary* | *€100* | *€1 = £0.60* |
| *European subsidiary owes US subsidiary* | *$500* | *€1 = $0.87* |
| *US subsidiary owes UK subsidiary* | *£200* | *£1 = $1.42* |

| | **UK sub £** | **Euro sub €** | **US sub $** |
|---|---|---|---|
| **UK sub** | (60) | 100 | |
| **Euro sub** | | (575) | 500 |
| **US sub** | 200 | | (284) |
| **Total** | 140 | (475) | (216) |

| | |
|---|---|
| *UK subsidiary receives net* | *£140* |
| *European subsidiary pays net* | *€475* |
| *US subsidiary pays net* | *$216* |

*FIGURE 2*

## It's not as easy as this!

*Exchange rates cannot be fixed in advance. Data is entered into the system and revised once fx deals have been executed. It is then necessary to revise the fx deals to settle exact position. In Figure 1 we ended up with 2 deals – sell €475 and buy £, buy $216 and sell £. If, when we came to deal, fx rates were actually €1 = £ 0.59 and £1 = $1.43 then settlement would change.*

| | **UK sub £** | **Euro sub €** | **US sub $** |
|---|---|---|---|
| **UK sub** | (59) | 100 | |
| **Euro sub** | | (593) | 500 |
| **US sub** | 200 | | (286) |
| **Total** | 161 | (493) | (214) |

*We inform the bank that we have slightly revised the deals to sell €493 and buy £ and buy $214 sell £. As movements are small the bank should have no problem in revising these deals.*

known currency positions with group suppliers and customers through the netting program.

Short-term borrowing and deposit positions can be managed through the multilateral netting system. The group is able to fund or take short-term deposits from individual subsidiaries by accelerating or delaying settlement of cross-border transfers.

**Establishing a multilateral netting system** – Multilateral netting systems can be very versatile and, in establishing such a system, the treasurer must evaluate the options available and the benefits and risks involved.

**Internal or outsourced?** – netting systems can be labour intensive and, in most cases, must be supported by a centralised treasury operation. Internal systems work well in a decentralised, non-uniform group. Outsourcing can be expensive; however, it removes the need for a centralised treasury to support the netting operation and works well in a centralised structure with repetitive transactions.

**Profit-making or non-profit making?** – Transfer pricing issues in the group may mean that subsidiaries should be charged for multilateral netting services. The group can monitor the effective cost of operating the service if a margin is added on to the exchange rate related to each transaction. But including a margin for the centre can be complicated and time consuming. Some netting systems do not offer this feature.

**Receipt or payment-driven, or both?** – Systems that are both receipt and payment-driven are flexible and versatile. In a payment-driven system only those balances agreed between parties are settled and balances under dispute may remain unresolved. In a receipt-driven system balances are settled on the instructions of the entity due to receive funds. These balances are prone to error and further transfers may need to be effected to correct the position.

**Settlement on a daily, weekly or monthly basis?** – If frequent settlement takes place, then the system should be capable of handling and recording several nettings simultaneously.

**Centralised or remote input?** – Remote input to an intranet site is attractive as centralised input can be labour intensive and prone to error. But the level of security and internal control required to ensure that data is not corrupt may prove expensive.

***Health warning***

The multilateral netting system offers few benefits to the treasurer unless it is properly supported by global cash management arrangements that ensure funds transfer is effected without loss of value and without incurring expensive transfer charges. Multilateral netting is labour-intensive.

If not outsourced, the system must be supported centrally and linked to the treasury management system to automate confirmation, settlement and recording of transactions. ■

*Caroline Shuffrey is an independent treasury consultant.*