Dealing with the dollar

IN THE FIRST OF A TWO-PART FEATURE, **WILL SPINNEY** EXPLORES SETTLEMENT AND CLEARING SYSTEMS IN THE US.

The US is the largest economy in the world and most businesses where treasurers are employed have some market presence in the US. It could be the business has a US subsidiary, where settlement and clearing systems are used daily, or that it trades with customers or suppliers in the US. And even where there is no US trading partner, the markets in which a business operates may be denominated in US dollars, as is the case in oil and gas and many other commodity-based sectors such as aerospace. Finally, treasurers may need to know about US settlement and clearing systems because of their own companies' capital market or foreign exchange activities, where so many transactions are linked to the US dollar in some way.

The US is not only a key trading partner in most regions of the world, but it also has systems that are different from those of the rest of the world due to the country's very particular banking structure. This two-parter turns the spotlight on the systems and information of importance to cash managers who operate in the US or in US dollars.

BACKGROUND The US is a large and complex marketplace with an equally large and complex banking system. Due to years of restrictions that have limited the operations of a US bank outside its home state, there are currently around 12,000 financial institutions in the US, of which about 7,200 are commercial banks (many are one-branch operations). As a result, companies with operations across the US require complex multi-bank arrangements to collect and disburse efficiently. And the banks themselves have to enter into arrangements and clearing processes that are unusual in developed markets.

Furthermore, the US dollar has been the primary currency for the settlement of international trade transactions for many years. Although many foreign banks maintain branches or strong correspondent relationships in the US to serve their own and their customers' clearing needs, many large non-US corporates find it necessary to set up bank accounts directly with US banks to handle their dollar business efficiently.

The number and value of international dollar payments has grown dramatically due to the growth in international trade and the volume of foreign exchange (FX) trading. Equally, increases in the volume of domestic money market trading, the emergence of more multinational corporations and the development of sophisticated cash management services have led to more money movements and so a need for efficient clearing and settlement systems.

New York continues to be the primary financial centre for international dollar payments, although other centres, such as Chicago in the Midwest and San Francisco on the West Coast, are also important. In New York, participants include local regional banks, institutions referred to as the "money center banks" (that is, large banks that borrow and lend to governments, corporations and other banks) and the Edge

cash management
US SYSTEMS

Act offices of non-New York banks, together with the New York branches of foreign banks.

Banks that operate under the Edge Act can undertake international business only in the US and cannot compete for domestic business. This legislation was necessary to give banks outside of New York access to this important marketplace without contravening state banking laws.

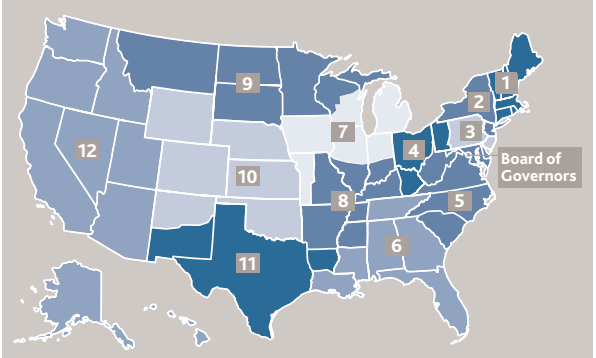
REGULATORY ENVIRONMENT The Federal Reserve was created by the US Congress in 1913 to serve as the central bank of the US. Commonly known as the Fed, it:

- supervises and regulates "depository institutions" (the myriad of bank and bank-like financial institutions);
- manages the supply of money and credit in the economy;
- issues notes and coins;
- provides banking services to the government;
- regulates and operates the payment systems; and
- makes short-term loans to and provides services for financial institutions.

Overseen by a board of governors, the Federal Reserve system consists of 12 regional banks (see Box 1), each of which covers a district. The 12 regional Federal Reserve Banks hold reserve and settlement accounts for their member institutions and provide such services as Fedwire money transfer and cheque clearing facilities, as well as operating many of the regional automated clearing houses (ACHs). The Fed is self-supporting and charges for its services.

CHEQUES Although volumes are declining every year, cheques are still a prevalent method of payment in the US with about 30 billion written a year. To be able to write cheques in dollars drawn on a US bank, a company needs to open a demand deposit account (DDA). A DDA is similar to a UK current account but with a few differences. First, Regulation Q prohibits the payment of interest on corporate DDAs (this regulation is under review). Second, corporate overdrafts are not permitted and other types of credit

Box 1: The 12 US Federal Reserve districts



1 Boston	5 Richmond	9 Minneapolis
2 New York	6 Atlanta	10 Kansas City
3 Philadelphia	7 Chicago	11 Dallas
4 Cleveland	8 St Louis	12 San Francisco

THE CHECK 21 ACT LETS BANKS CLEAR CHECKS ELECTRONICALLY WITHOUT HAVING TO PRESENT THE ORIGINAL ITEM.

facilities need to be agreed to handle temporary cash shortfalls. Cheques are used:

- when the beneficiary's bank account details are not known (it is not usual in the US to provide bank account details on an invoice or statement);
- where additional documents need to accompany the payment (e.g. a remittance document); and
- if the drawer of the cheque can benefit from mail and clearing float by delaying settlement. It should be noted, however, that electronic clearing is rapidly eroding the float associated with cheques.

COLLECTION METHODS Unlike most countries, the US allows cheques to be collected in a number of ways. The method selected depends on the physical locations of both the bank of first deposit and the drawee bank. The major collection options (see Box 2) are:

- The Federal Reserve system. The Fed provides a nationwide cheque collection facility. Each regional Federal Reserve Bank clears cheques between its own member banks and forwards items to other regional Feds that are drawn on their members. Settlement occurs through the members' reserve accounts held with the local Fed.

- Regional clearing house associations (such as The Clearing House in New York). The clearing houses provide cheque collection facilities for member banks, calculating net settlement amounts between members and then debiting or crediting members' reserve accounts at the appropriate regional Federal Reserve Bank.

- Bilateral arrangements, known as direct send networks. Correspondent banks exchange cheques drawn on each other as well as items drawn on each other's clearing region. Settlement is made through the correspondent bank accounts each holds for the other. These networks are established to reduce the cost of clearing through the Fed or clearing house, as well as to improve funds availability.

- Cash letters. These are similar to direct send networks but are not as formalised and may not operate bilaterally or every day. Cash letters consist of a batch of cheques itemised on a paying in or deposit slip, which is delivered by courier or mail directly to a local bank in the clearing district on which the cheques are drawn. Once again, settlement is effected across correspondent accounts.

Most large US banks make use of all four collection methods, selecting the most appropriate for each item, based on the

location of the drawee bank, funds availability, price and any additional costs such as mail or courier charges.

The Check Clearing for the 21st Century Act (commonly known as Check 21) has had a major impact on the way banks clear cheques. The legislation lets banks clear checks electronically without having to present the original item. Banks that are not capable of processing electronic items have to accept substitute cheques or image replacement documents (IRDs).

Other initiatives to accelerate cheque processing include converting cheques issued by consumers into ACH debits at the point of sale (this includes phone and online purchases), lockbox and remittance locations. On the corporate side, many of the larger banks now offer services that allow a company to deposit cheques by scanning them in their offices, creating an image-based deposit that is then transmitted to the bank for posting. Remote deposit capture, as this is called, has fuelled the growth of "e-checks" (cheques that clear electronically). Although paper cheques are expected to continue to decline, e-checks have been growing very rapidly.

BEST METHODS So how does a non-US-based company make best possible use of US cheques? First, when looking at the use of cheques from outside the US, disbursements and collections should be considered separately.

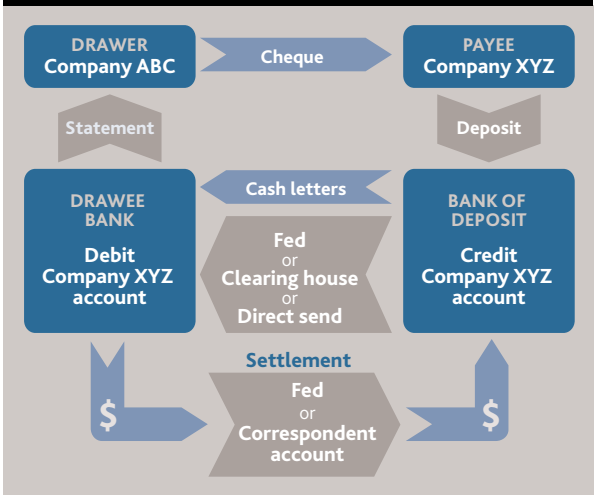
Disbursements Companies dealing with customers in the US on a regular basis may find that a dollar account is the most cost-effective way to settle their lower value payments. A number of London-based insurance companies and brokers settle small claims in this way.

Although it is likely that a company will have a standard chequebook, computerised cheque issuing facilities are more common for major companies. Banks readily supply cheque forms in continuous format for this purpose and some banks offer PC-based cheque printing services that are available to users outside the US. The cheques are printed at the issuer's premises and the software usually includes a reconciliation module. Enveloping and transmission to the beneficiary are the responsibility of the issuing company.

Many banks allow companies to transmit disbursements directly from their accounts payable system. The bank then prints and dispatches the items that are to be paid by cheque to beneficiaries in the US. Although more expensive than the print/dispatch-it-yourself products, these can still be more cost-effective than wire transfers, particularly when part of an outsourced payments service and the bank is prepared to share the float with its customer.

Float sharing on cheque issuance products is becoming more common. Disbursement float is defined as the time taken from the day on which the cheque is issued to the day that it is debited to the drawer's account. With electronic cheque products, the bank normally debits the drawer immediately and has the use of the funds until the cheque is presented. Float sharing may be handled in one of two ways: either by allowing the drawer to pay for cheques issued a few days after issue, or by calculating the value of the float by item and dividing up the benefits gained on balances minus the cost of the transaction fees between the banker and the customer on a pre-arranged basis.

Box 2: Clearing cheques in the US



Companies based outside the US may draw cheques on their accounts held with US banks for the settlement of international transactions. Beneficiaries outside the US, however, are likely to find this an acceptable form of payment only if they also maintain a dollar account in the US. If they do not have a US account, the collection process can be very long and costly.

Collections A company located outside the US that is being paid by cheques drawn on US banks is likely to be subjected to high collection charges and long float periods. If this is a regular occurrence, the company should consider using a lockbox service. The company can then instruct its clients to forward the cheque and remittance documents directly to the lockbox provider in the US. If customers are widely spread throughout the US, the company may need more than one lockbox. Cleared funds in the collection account can then be zero-balanced by each bank to the company's concentration account at its main US bank. Once in the concentration account, the funds can be converted and repatriated to the company's domestic bank when required.

Some banks have extended the use of remote deposit capture technology to overseas collections. Developed in response to Check 21, which permits clients and banks to collect cheques electronically, remote deposit capture allows companies to transmit images of dollar paper cheques to their bank of deposit for speedier processing. While this is principally a domestic service, a number of providers now offer this service cross-border.

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Part 2 of this feature will appear in the spring 2011 edition of the Cash Management supplement and will cover the automated clearing house system, FedWire and CHIPS.