# CHALLENGES OF NETTING

NETTING CENTRES ARE THE WAY AHEAD FOR MULTINATIONAL COMPANIES LOOKING TO CENTRALISE THEIR TREASURY ACTIVITIES, SAYS **SIGRUN LENZER** OF COMMERZBANK.

Multinational companies are striving more and more to achieve centralisation of certain treasury activities. Often, they start with cash pooling, in which they can achieve liquidity and interest optimisation within the group by concentrating their bank account balances to one master account.

When treasurers look at implementing cash pooling, if there are inter-company invoices, the question often arises of why they do not first implement a netting process. In comparison with introducing a netting procedure within the group, establishing a cash pool is likely to result in more resistance within the group because subsidiaries no longer have deposit balances in their bank accounts and think their banking relationship might be reduced.

Our customers' experience is that it is easier to achieve acceptance for the establishment of a netting procedure than for cash pooling arrangements, because the entities will receive physical remittances in respect of inter-company receivables that can then be deposited locally.

A cash pooling scheme could then form the next step so that, in the final structure, no netting transfers to or from bank accounts are required because these are eliminated by cash pooling.

## OBJECTIVES OF NETTING

A netting process is typically established in multinational companies that have many production and sales divisions, which therefore generate many inter-company invoices.

The result of these invoices is a significant quantity of commercial bank transfers. When the group is established worldwide, this is accentuated by the need to execute cross-border bank payments. These payments can made through wireless cross-border transfers or by cheque. This causes high bank fees (because of cross-border transfers), administrative costs and currency conversion costs.

Multilateral netting is a mechanism consolidating inter-company transactions and calculating settlement requirements internally. The advantages of a netting process are as follows:

- it introduces discipline into the inter-company settlement process, achieves transparency of intercompany payment flows and improves operating efficiency; and
- reduces the number of cross-border payments, with resultant savings in bank charges for payments and conversion costs for currencies.

The higher the number of inter-company invoices, and the smaller the nominal amounts of the invoices, the more beneficial the system becomes (see *Figures 1* and *2*).

## FUNDAMENTAL DECISIONS IN ESTABLISHING A NETTING PROCESS

It has to be agreed whether the netting will be a payable- or receivable-driven process, or both. Usually it takes place once a month and is often a receivable-driven netting. Why receivable-driven? The motivation to participate in a netting process is much higher when expecting money in than when paying it out.
It also has to be agreed whether the netting centre will be the company (for example, the parent company), or if the procedure will be outsourced to a service centre, which could also be a bank. The advantages of outsourcing the netting process are the elimination of the need to buy technology for a netting system and a reduction in manpower.

When outsourcing the process to the bank, it is also possible to arrange with the service provider that it is also responsible for the transfer of the netted amounts with good value from/to each participating entity's bank account.

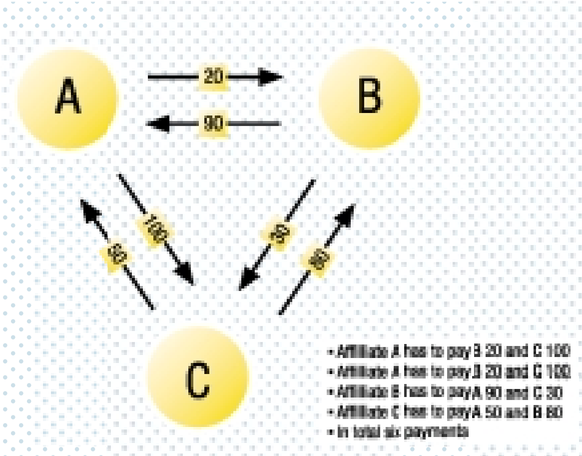
Some participants have to pay different currencies but prefer to pay/receive the netting amount in the currency of their own country. Therefore, it has to be agreed at the outset which currencies are to be used, as well as the base netting currency for calculation purposes.

## NETTING SYSTEMS

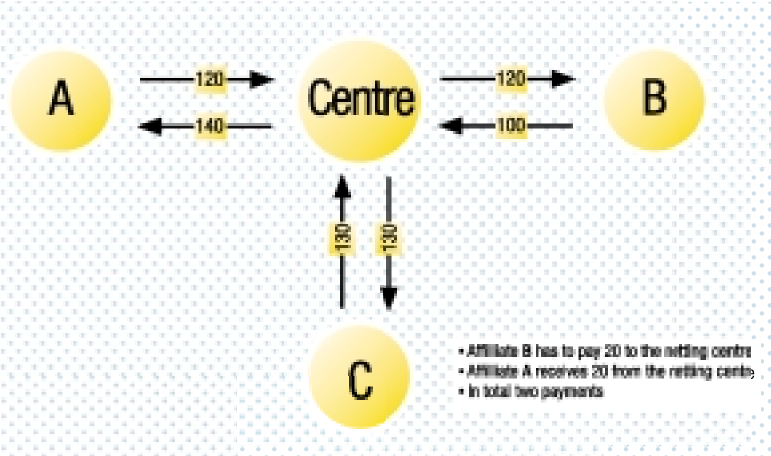
There is a wide range of netting systems on the market, which can be either software- or internet-based. The internet-based systems have the advantage that all participants have easy access to the netting centre worldwide. Nevertheless, the interface to an in-house system is vital to achieve straight-through processing (STP) by importing invoicing data automatically. In our experience, the in-house invoicing/financial systems of each subsidiaries are often different.

Is the internet-based system able to upload invoicing data from your financial/invoicing system? If it is, will the netting system provider charge per netting participant using this internet application? These are important factors when selecting a system. When using software-based systems, there is also the question of interfaces.

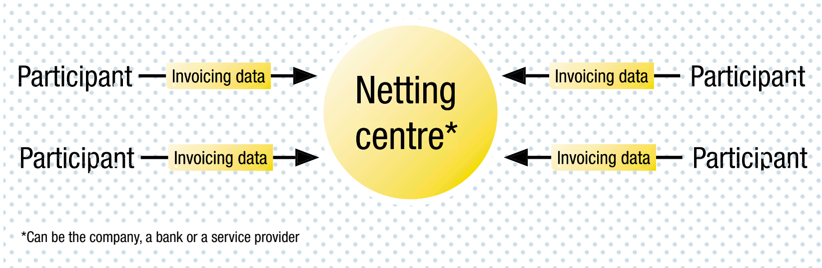
▪ Figure 1
Before establishing a netting process




▪ Figure 2
After establishing a netting process




▪ Figure 3
Netting process




When your in-house invoicing/financial system is able to download an Excel file, almost every netting system is able to match this file. The files can be sent by email to the netting centre and will be matched automatically. Comparison with the internet-based system, this could be a workable and cheaper solution.

If there is no interface to your in-house system, the participants can enter their data into a pre-defined spreadsheet.

## NETTING PROCESS

**NOTIFICATION OF INVOICES.** The netting centre will receive all receivable data from the netting participant up to a pre-determined date. A description of the interface for further automatic processing of invoice data has to be provided. If the receipt is later than the pre-defined date, it will be deferred to the next cycle.

The net positions have to be calculated for each netting participant. If there are to be different currencies, the inter-company obligations will be calculated in a common currency (for example, in euros or US dollars). For this to happen, the netting centre has to determine *indicative rates*.

This indicative rate helps the centre determine the amount each participant would pay or receive. The buying and selling rate of the indicative rate is identical (that is, there is no bid/offer spread). This rate is used for calculating the initial conversion.

When all positions are settled, there is a need to buy or sell certain currencies, which might result in a residual amount because some participants buy more internally than they sell internally.

It has to be agreed who buys or sells the currency shortfall or surplus (usually the netting centre). This trading is generally done on a spot basis. The centre will then use the rates obtained in its dealing and arrange a **pre-netting** that applies these rates to each participant's obligations – in place of the indicative rates used earlier – and this has to be confirmed by each participant.

Next, each participant that has to pay a net position will instruct its bank to arrange the outstanding amount on a pre-defined date. The netting manager is notified of the participating banks and accounts in advance. If a bank is performing the functions of the netting centre, it can do so on behalf of the participants and debit or credit the participant's accounts.

The **final-netting** usually starts two days from the pre-netting and reflects the fact that the netting centre has dealt the currencies. The final-netting date corresponds with the final payment date in a traditional third-party transaction (bank transfer from/to netting centre account). The main tasks of a netting centre (see Figure 3) are:

- processing invoicing data;
- the calculation of the net position (notification, pre-netting and final-netting);
- conversion of currencies per participant;
- foreign exchange dealing;
- communication of the respective information to each participant; and
- controlling the netting accounts of each participant.

Once the netting system is established, a high degree of satisfaction is often experienced among subsidiaries, as they retain control of their own funds and get paid on time.

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