Beyond sterling

WILL SPINNEY LOOKS AT WHEN AND WHERE A BUSINESS SHOULD OPEN A FOREIGN CURRENCY ACCOUNT, AND HOW TO EVALUATE ITS EFFECTIVENESS.

When a company's international business grows, and the volume and value of payments being made or received in foreign currency become significant, it is time to consider whether to open a foreign currency account. If the decision is to proceed, the next question is where to maintain the account.

If a company in the UK needs to make and receive US dollar payments it can open an account in the US, typically in New York. Maintaining an account in the currency centre has some advantages but also some practical difficulties such as paying into an account several thousand miles away, obtaining balances or account information, and making payments out of the account.

Recognising that some companies prefer not to deal with accounts overseas, banks also offer currency accounts domiciled outside the currency centre but close to the customer. US banks in London pioneered this service in response to the development of the Eurodollar market in the 1960s. Today, most major financial centres allow accounts to be maintained in all major currencies through a single bank.

It is important to note, however, that offshore currency accounts are merely an accounting accommodation provided by the banks to their customers. The actual underlying currency account resides with the bank's own "nostro" account in the country of domicile for the currency, through which all customer payments and receipts are actually settled.

The alternative for the UK company with US dollar payments and receipts, therefore, is to open a US dollar account with a bank in London. The bank in London maintains its nostro account with a bank in the US. Entries over the customer's account are reflected as entries over the bank's own account in US dollars in the US. Even though banks offer currency accounts from branches around the world, ultimate settlement takes place across their nostro accounts in the currency centre (i.e. the currency remains in its country of domicile). This is the major reason for the inefficiency and expense involved in collecting a foreign currency cheque, especially if drawn on a bank outside the currency centre.

WHEN TO OPEN A FOREIGN CURRENCY ACCOUNT The time to open a foreign currency account is when the volumes and values of transactions in a particular currency have reached the right level for it to be cost-effective. The right level varies between companies. The basic questions to ask here are:

- Does the company invoice for goods or services sold in the local currency of the country?
- Does the company invoice for goods or services bought in in the local currency of the country?
- Does the company buy and sell in the same currencies?

Unless the answer to the first two questions is "yes" in each case, a foreign currency account will probably not be required (although it may be if the values or volumes are relatively high). If the answer to the third question is "yes" for any

When to open a foreign currency account

EXAMPLE 1: A COMPANY IN SINGAPORE

- **Scenario** The company invoices Singapore-manufactured goods in euro to clients in France. Orders are irregular, and during the past year the company has received five payments averaging €100,000 each. The company has no selling expenses in France.
- **Recommendation** As all production expenses are in Singapore dollars, the company would have no need to hold euros. A currency account would merely create an ongoing exposure and additional expense. The company would do better to use a spot FX contract to sell its euros for Singapore dollars immediately on receipt, for a currency it actually needs. The company's bank would do the spot deal automatically and apply the Singapore dollar value of the euro receipt to the Singapore dollar account. It should be noted, however, that the exchange rate achieved would be relatively unattractive compared with rates available for larger amounts.

EXAMPLE 2: A COMPANY IN THE US

- **Scenario** A publishing company in the US invoices customers in the Netherlands in euro. Orders for annual magazine subscriptions average around $60 per item and there are 15,000 orders a year. The company has no expenses in the Netherlands.
- **Recommendation** Despite the low value and one-way flow, the volumes alone may make the use of a euro account advisable. The cost of collecting high volumes of low-value foreign payments would be prohibitive, and maintaining a bank account in the same currency in which sales are invoiced should simplify sales ledger maintenance and reconciliation. The euro account should be cleared out regularly and euros sold for US dollars, which should be remitted to the US.

Another option would be for the company to accept credit card payments in euros and arrange with the card acquirer to credit the proceeds in US dollars. This would depend on both the acceptance of making credit card payments in the local market and the cost of accepting payment by card versus opening up a local account. This option would work only if 100% of payments are made by card; otherwise, the problem of handling any residual payments cost-effectively remains.

EXAMPLE 3: A COMPANY IN HONG KONG

- **Scenario** The Hong Kong-based company exports goods to Malaysia on a regular basis. The average value of goods invoiced in Malaysian ringgit is MYR50,000 and there are about 20 such sales per year. The company has a small sales office in Kuala Lumpur and so has some local expenses. It also buys raw materials from Malaysia, which are exported to Hong Kong. Annual payments for imports the previous year totalled MYR650,000.
- **Recommendation** A MYR non-resident account would be appropriate in this situation for a number of reasons: to collect receivables, fund local expenses, pay for purchases of raw materials, and act as a natural hedging mechanism.

Only the net residual funds (MYR350,000 less local expenses) need to be converted to Hong Kong dollars and repatriated when required. It is likely that the Malaysian sales office will also have its own resident MYR account. It should also be noted that there are exchange control regulations in Malaysia that require reporting of capital flows from resident to non-resident accounts and flows out of the country.

EXAMPLE 4: A COMPANY IN GERMANY

- **Scenario** The company imports raw materials from Poland. Orders are monthly and denominated in US dollars. Average values are US$500,000 per month and the company has no sales to Poland, although it did have two dollar-denominated sales last year to customers in the US and Hong Kong totalling US$250,000.
- **Recommendation** This company probably does not need a currency account. It regularly buys substantial amounts of dollars to pay for raw materials, so if the payment dates are certain and known in advance this can probably be done through forward exchange contracts. If payment dates are not certain, the company will have to wait until receipt of the invoice and then do a spot transaction.

In terms of the payment side, a currency account adds no value when the funds are not needed as a natural hedge unless FX rates are uncompetitive and the company wants to time the transactions. The costs of maintaining an account for this purpose, however, may be prohibitive.

This case illustrates a subtle distinction between the FX dealing mandate and the bank account mandate. Banks are commonly restricted from remitting proceeds of an FX deal to a third party. However, banks can accept an instruction issued in accordance with the bank account mandate to pay a third party in a foreign currency, by reference to an agreed rate and with settlement over the payor's nominated bank account.

On the sales side, these dollar collections could be sold through an FX contract for euro on receipt. The dollar receipts are relatively low in volume and amount and by no means regular, so the potential for a natural hedge would still not make it worth opening a dollar account as the overall benefit is negligible.

currency, an account may be advisable to take advantage of any "natural hedges" (when receipts can offset payments in the same currency) and to avoid "round-tripping" (when a currency is both bought and sold within a short timeframe, with FX commissions and spreads on both transactions).

A cost/benefit analysis needs to be completed for each currency if the answers from these three questions indicate a currency account may be warranted. The analysis should cover:

- **What charges/costs are incurred by not having a currency account?** This should cover FX commission/spread, interest loss (float), transfer costs, not having access to local payment systems, and more expensive cross-border transactions.
- **What additional charges/costs are incurred in opening a currency account?** This should cover maintenance fees, balances (idle funds), administrative time (e.g. accounting, reconciliation, mandate and control environment maintenance), additional auditing burden, and additional services such as balance reporting.
- **What are the liquidity, FX and interest rate risks with and without currency accounts?** For example, access to funds, security of funds, FX transaction risk, interest earned or charged, and basis.
- **Other business implications of having, or not having a currency account**. These include additional charges to customers for making payments, competitive perception of not having a local account, and added costs of doing business.

The four examples given in the box on page 13 illustrate under what circumstances opening a foreign currency account is appropriate.

WHEN TO CLOSE CURRENCY ACCOUNTS In an ideal banking structure, companies should have as few currency accounts as possible because they are costly to run and can create currency exposures. Therefore, all accounts should be reviewed regularly to ensure they are still needed. Trading patterns change, and banking structures and accounts need to change with them.

WHERE TO HOLD CURRENCY ACCOUNTS There are a three main location options when opening a currency account: central, regional or local.

Central domiciling involves holding the account in the company's home location. For example, a UK company using central domiciling would hold its sterling and currency accounts at the same bank in London.

Local domiciling involves holding the account in the country of the currency. For example, a US company might hold an account for sterling in London, one for euro in Frankfurt, one for Danish krone in Copenhagen, one for Singapore dollars in Singapore and one for US dollars in New York.

Regional domiciling involves holding all the accounts in a third location, such as the regional treasury centre. For example, the International Financial Services Centre (IFSC) in Dublin holds accounts in euro, sterling, US dollars and Norwegian krone in London.

Table 1: Domiciling models compared

ISSUE
Banking relationships
Transfers between local currency and foreign currency accounts Note: cost, value dating and float aspects also need to be investigated, and will differ by currency, country and the bank used
Cut-off times for payment and receipts
Cheque deposits
Receipt of credit transfers from customers in country of currency
Balance reporting and statements
Interest on credit balances Note: withholding tax rules and rates on interest paid will differ between locations
Problem resolution and help
Language
Tax and permanent establishment
Acceptability of cheques for payments Note 1: even within euro zone, cheques are still cleared on a national basis (SEPA does not cover cheque payments), so a euro cheque drawn on a bank in another euro zone country other than the customer's country will not be acceptable Note 2: in many countries (e.g. Netherlands, Germany and Poland), corporate to corporate obligations are not settled using cheques
Delivering payment instructions to bank Note: costs also need to be compared as well as value dating practices and local banking conventions
Commission/transaction fees

CENTRALLY DOMICILED	CURRENCY CENTRE
■ Company can use same bank as used for local currency account	■ Company likely to need new relationship, possibly with a different bank
■ Easy transfer of funds – will require entries across bank's vostro/nostro accounts	■ Requires cross-border funds transfer ■ May be central bank reporting requirements ■ Cross-border flows may be restricted
■ Much earlier ■ Sometimes payment cut-offs are one day prior ■ May lose one day's value on receipts	■ Much later ■ Enables same-day value, in line with local regulations, for payments and receipts
■ Easy to pay in ■ Take longer to clear ■ More expensive to process	■ More difficult to pay in unless remitted directly to the currency centre ■ May need to use a lockbox or cash letter service ■ Cheap and fast to clear
■ May not be able to receive ACH (automated clearing house) credits ■ Payor must arrange for funds to be sent to the receiving bank nostro account and so could lose a day's value ■ May be more expensive as international payments are being received	■ Credit from local payers will reach the account at the fastest speed the bank's system allows ■ Beneficiary may have to wait several days for the bank's advice of the receipt of funds (unless using cross-border e-banking to monitor the account, when it will typically be next day) ■ Can receive payments from all domestic systems
■ The company can collect daily statements from bank along with LCY (local currency) accounts, or the account details could be reported using same e-banking system used for LCY accounts	■ The company may wait many days for a paper statement to arrive by mail. If the bank can report electronically, it may send a customer statement via SWIFT to the customer's lead bank (using an MT940), or the company may take another e-banking system from the account-providing bank
■ Credit interest, if available, will be close to market rates due to customer leverage	■ Credit interest not always available, and may be at lower rates than from domestic bank ■ Non-resident accounts do not always have access to same rates as for resident accounts ■ May be subject to withholding taxes
■ No time difference and can leverage local relationships	■ Time zone differences can cause contact problems ■ Relationship may be more remote
■ No language problems	■ Local banks may not have staff who speak customer's language
■ Neither should be a problem	■ Either or both could be a problem – should be fully investigated ■ Withholding taxes may not be recoverable/offset against income
■ A cheque drawn on a bank in a country other than that of the currency is not normally acceptable to the beneficiary (e.g. a euro cheque drawn on euro account in London that is sent to a German company) ■ Slow and expensive to clear ■ In some countries, chequebooks are not allowed on foreign currency accounts	■ Local cheques are perfectly acceptable in domestic market ■ Fast and cheap to clear ■ In some countries (e.g. in Central and Eastern Europe), non-residents are not always allowed to hold chequebooks on offshore accounts
■ Easy – company can deliver signed letter or use e-banking platform	■ Mail times preclude letters ■ Fax may not be accepted due to high security risks ■ Phone may be acceptable only with call-backs or security codes ■ E-banking may be best alternative, if available, but may be more expensive for multiple systems
■ As all entries are doubled up (across companies' accounts and banks' nostro/vostro accounts, plus SWIFT messages), costs are normally higher	■ Lower domestic transaction pricing

Regional domiciling often occurs for reasons other than transactional operations, such as liquidity management (pooling) or to settle FX trades transacted in London. For the purposes of the discussion that follows, such accounts will be considered as having the same attributes as domestic domiciling – i.e. currencies are being held outside of their currency centre.

IN AN IDEAL BANKING STRUCTURE COMPANIES SHOULD HAVE AS FEW CURRENCY ACCOUNTS AS POSSIBLE BECAUSE THEY ARE COSTLY TO RUN AND CAN CREATE CURRENCY EXPOSURES.

One consideration is that while it has never been easy to open a new account, especially one overseas, modern anti-money laundering and know your customer regulations requiring banks to verify the identity of account holders and provenance of funds can make it a very painful process. The documentation requirements can seem overwhelming. Changes to signatories can also be very time-consuming.

One development which has helped companies make payments from accounts located in the currency centre is SWIFT MT101 messaging. This allows the company to make payments from all of its accounts through a single e-banking platform, assuming that bilateral agreements are in place. This may be one of the major criteria a company uses in selecting a bank to hold its currency accounts.

Security is the big issue when making payments, and the more remote the originator from the domicile of the account, the greater the security procedures that may be required to authenticate the instruction. Banks have developed a number of different ways to achieve this using passwords, tokens and keys, and SWIFT has developed a universal token for personal digital identity verification.

Will Spinney is ACT associate director for education.
wspinney@treasurers.org

The second part of this feature will appear in the next issue of Cash Management and will cover the terms and conditions of foreign currency accounts.

Table 2: Considerations when making payments from a currency account

METHOD	CENTRALLY DOMICILED	CURRENCY CENTRE
Signed letter	■ Manual and labour-intensive ■ Totally flexible but prone to fraud	■ Postal system slows receipt ■ Totally flexible but prone to fraud
Phone call	■ High risk to bank and company, even if supported by strictly limited mandate ■ Discouraged by the banks	
Fax	■ High risk to bank and company – shares limitations of telephone instructions, together with increased risk of fraud ■ Strongly discouraged by the banks	
Tested fax	■ Rarely offered – domestic banks prefer companies to use their proprietary e-banking services for funds transfer instructions	■ Better than untested fax or phone, but also discouraged
Electronic funds transfer from workstation	■ Low-cost, secure, and less prone to error ■ Inefficient for high volumes ■ Can be attractively priced to encourage use ■ MT101 may be an option	
Mainframe to mainframe (file delivery)	■ Used by larger companies with their relationship/payments outsourcing banks ■ Good for bulk payment or receipt initiation from ERP systems	■ Probably not appropriate in all cases ■ Good for bulk payment or receipt initiation from ERP systems
Disk delivery	■ Delivery process can slow down receipt ■ Very small but high-capacity media may present a significant risk if lost or compromised ■ Prone to fraud ■ Many regions no longer accept disk submissions	
Internet delivery/secure email	■ Increasingly used with certain e-commerce applications especially with smaller companies but security concerns persist over using the internet for high-value payments	