LIQUIDITY IN LATIN AMERICA

COMPANIES OPERATING IN THIS UNPREDICTABLE REGION HAVE A WIDE RANGE OF STRATEGIES THAT CAN HELP THEM TO REDUCE RISK AND MAKE OPTIMAL USE OF THEIR CASH, WRITES ODETTE IZQUIERDO

Slowing economic growth and increased FX volatility in many Latin American countries are prompting companies with operations in the region to seek to better manage their risk and improve their efficiency.

While Latin America has a reputation – deserved in some instances – for high levels of regulation, there are opportunities to manage FX and other risks effectively and to improve operational and liquidity management efficiency. Below are four key ways in which corporate treasurers can achieve their liquidity management objectives against an evolving economic and regulatory backdrop.

1. Rationalise bank relationships and bank accounts

In the years since the 2008 financial crisis, many companies have re-evaluated their banking relationships. Historically, companies in Latin America have tended to accumulate additional banks as they entered new markets (either organically or through M&A). This makes it difficult to mobilise funds and results in fragmented visibility and information, connectivity challenges, problems with reconciliation, and multiple points of contact for relationship and customer service.

Moreover, corporates' processes for selecting banks have seldom been rigorous. Often, if a bank with which a corporate has an existing relationship has operations in a country where the company needed a partner, that bank was simply mandated.

The shock of the financial crisis, and the weakness of many banks in the years that followed, means that treasurers are now intently focused on the credit quality of their company's partner banks. The introduction of the Basel III regulatory framework, which increases the amount of capital that banks must hold, and the US Federal Reserve's Comprehensive Capital Analysis and Review, which evaluates the capital-planning processes and capital adequacy of the largest US-based bank-holding companies, have further highlighted differences between banks in terms of financial strength.

Corporates have responded by rationalising the banks that they work with, usually by selecting a single regional partner bank and then choosing a local partner bank in markets where additional services are required (such as cash collection or employee services, for example). By working with a single regional partner bank, it is easier to automatically concentrate funds, centralise visibility (including through integration with enterprise resource planning systems) and standardise payment processes (potentially opening up the possibility of centralisation of payments in the future).

Bank relationship consolidation (as well as bank account rationalisation) might also help to reduce fees and streamline funding and control of multiple accounts. Partner banks and clients can work together to achieve benefits for all parties. Clients can leverage their regional/global relationships to increase their bargaining power, while banks can take advantage of opportunities in markets where liquidity is needed.

Fortunately, the drive by companies to concentrate their banking activity with a smaller group of banks comes at the same time as regulatory change. Most obviously, Basel III's liquidity coverage ratio (LCR) is encouraging banks to focus more on client selection and increasing the range of business they do with their chosen clients. The LCR distinguishes between different types of client assets in terms of capital requirements: overall, it encourages banks to seek corporates' operational deposits (ie those that are linked to specific operational services), while making short-term excess relatively unattractive for banks. Latin American clients have to evaluate their short-term investment policies in order to enhance returns in this new environment, especially given the backdrop of slowing growth. It is therefore advantageous for both banks and corporates to optimise the 'share of wallet' that is allocated to a bank.

2. Use regional treasury centres

Companies across Latin America increasingly want to aggregate regional balances and automate cash mobilisation so that operational risk – and frictional cash – are reduced. Ideally, companies would like to sweep credit and debit balances from source accounts into a nominated header account to achieve pre-specified targeted balances in all source accounts (often zero) on a regular basis. This way, liquidity can be optimised and surplus funds can be effectively invested.

Self-funding between entities within the same group also considerably reduces interest and overdraft costs. In addition,

> In the years since the 2008 financial crisis, many companies have re-evaluated their banking relationships

SAUL GRAVY/GETTY IMAGES

a regional treasury centre can take responsibility for FX management and other functions (including intercompany loans, for example).

Yet the diverse (and often restrictive) regulatory environment in Latin America, where each country has different rules and requirements, makes it challenging to implement a single regional treasury centre for liquidity management.

Instead, corporates are increasingly establishing treasury centres that serve a cluster of markets, such as Peru, Chile and Uruguay, which have common characteristics or the necessary tax treaties to facilitate effective liquidity management. Similarly, economies with high levels of regulation can be clustered, with flexible investment policies implemented to overcome high inflation risks, for example. This pragmatic approach to liquidity management takes into account the challenges and restrictions that exist in the region, but still enables companies to achieve their broader regional treasury objectives and optimise efficiency. It also leaves open the possibility for further regional consolidation of treasury activities as regulations change.

Regional knowledge should be combined with a global perspective

3. Manage cash efficiently

FX and other regulations in some Latin American countries, such as Argentina and Venezuela, can make it difficult to move money easily; while in other countries, such as Brazil and Colombia, it is impossible to move money automatically. These restrictions make liquidity management challenging. Moreover, notional pooling, which offsets debit and credit balances in different locations, is infrequent within Latin America.

While intercompany loans could create tax implications, some corporates find that these are outweighed by the economic benefits from managing intra-affiliate group cash flow and reducing reliance on costly bank funding. Banks are constantly evolving their infrastructure to provide complex solutions that can help multinational corporates to manage arm's-length pricing and thin capitalisation rules, depending upon the jurisdiction of each participating affiliate.

Other possible solutions include re-invoicing, which is often managed from a centre in Panama, Uruguay or Europe. Companies implementing re-invoicing solutions in order to centrally and efficiently manage their commercial flows within the region (ie to improve operating efficiency) have found that re-invoicing can enable them to achieve cash optimisation benefits, even in restricted markets.

For example, a corporate's commercial unit may purchase final goods from a manufacturing unit and manage the final sale to the end buyer, either a third-party customer or a division within the company. These transactions are carried out in the affiliate's local currency and therefore the commercial unit absorbs the FX exposure (in accordance with local transfer pricing rules). The group benefits from centralised management of intracompany flows and better forecasting of liquidity and FX exposure. Cash-rich companies use this contract-manufacturing model (which is in accordance with local transfer pricing rules) to reduce the reliance of local affiliates on market funding.

4. Manage FX risk

Corporates are eager to manage FX volatility, which has increased for some Latin American currencies in the past year as the economic outlook has deteriorated. Hedging could be one option, but it can be costly and many companies are taking a broader look at their operations and treasury in order to enable them to manage FX risks more holistically.

One option is to align receivables and payments in the same currency so that the company creates a natural hedge; another is to use US dollars, when possible, as a functional currency. Alternatively, forecasting can be improved so that FX exposures at a local level can be matched at a global level, eliminating the need to use the spot market.

Another possibility is the use of working capital financing loans, which have the potential to significantly limit the FX risk that results from issuing a local currency purchase order when costs are in US dollars. For example, where a US manufacturer exports to Latin America, the local commercial unit would take a loan (in local currency) to cover the purchase order, and then convert it to US dollars to pay back the US parent. While this entails a borrowing cost for the local entity, in markets where currencies have fluctuated in value by 5-10%, these costs may be worthwhile.

The right partner

The uncertain economic environment in Latin America is increasing the need for companies to effectively manage their risks. Latin America remains complex in terms of FX and other regulations that impact liquidity management. Yet solutions are available to meet many of the challenges facing companies that operate in the region.

For companies to achieve their liquidity-management goals in Latin America, they need to work with a bank that has solid experience and deep knowledge of local and regional conditions. Firms need a regional partner that places Latin America at the heart of its strategy, particularly as some global and multi-regional banks are scaling back their activity in the region.

Regional knowledge should be combined with a global perspective and market-leading solutions. This way, multinationals – and multi-Latinas (firms that start in one Latin American country and spread throughout the region) – can ensure that their treasury is as efficient as possible and that they can leverage structures, such as regional treasury and re-invoicing centres, and implement strategies to effectively manage market risk, while ensuring optimal standardisation, visibility and cash forecasting.

Odette Izquierdo is head of liquidity management, Latin America, at Citi