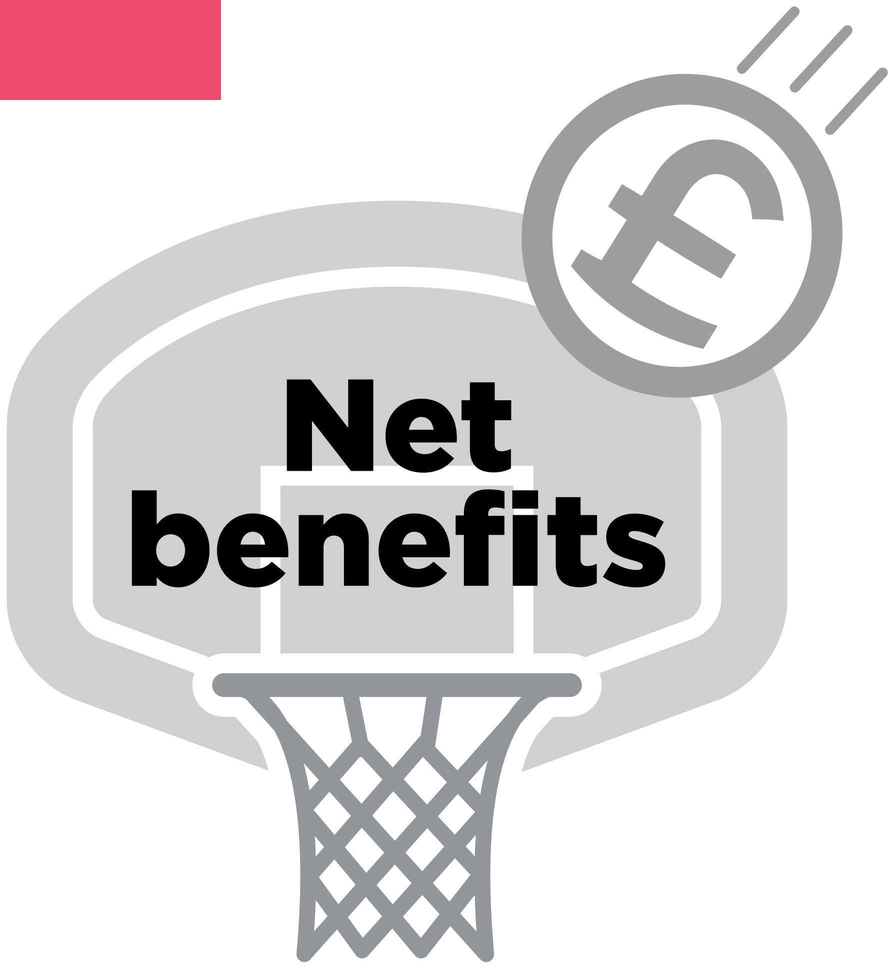

Net benefits

Netting is a simple and powerful tool, with important practical and assessment challenges. Doug Williamson investigates

Netting offsets receivables against payments due, to reduce net payments and save transaction costs. This frequently assessed topic is one of the key tools used by companies that have a centralised treasury function. The benefits of netting can be quick and substantial, especially if there is a lot of intercompany trading.

Immediate savings

Netting reduces the number, average size and cost of payments. This is because:

(1) Only those with a net obligation make a payment.
(2) Those making payments only pay net, after deducting receivables.
(3) Fewer and smaller payments will usually be much cheaper.

As a result of the reduction in payment flows, there are also substantial benefits from reduced:

- FX commissions; and
- Losses arising from money being in transit ('float').

Bilateral netting

Let's assume we are a British, sterling-based company. Let's say we are due to pay €800,000 and, at the same time, we are owed €785,000. In the absence of netting, the total amount of all the gross payments and receipts would be:

€800,000 + €785,000
= €1,585,000

With bilateral netting, our payment is reduced from €800,000 to our net obligation of:

€800,000 – €785,000
= €15,000

Transaction comparison (€000)	Without netting	With netting
Payable	800	15
Receivable	785	-
Transaction total	1,585	15
Number of transactions	2	1

In this simple example, our number of transactions is halved, from two to one. The money volume of transactions is reduced more than a hundredfold, from €1,585,000 to €15,000, with immediate cost savings.

Save more

Most groups of companies use 'multilateral netting' to save even more. Multilateral netting is where three or more parties agree to net their obligations.

Multilateral netting can be within a group of companies or a collective of third-party participants. In the rest of this article, we'll focus on groups of companies.

SAVE EFFORT

The United Arab Emirates' Easa Saleh Al Gurg Group created a centralised treasury department, complete with in-house bank, to consolidate cash management responsibilities that had previously been dispersed among the 23 different companies within the group.

Using a treasury management system, it now carries netting across all its bank accounts on a daily basis. Previously, getting consolidated daily cash balances across the group used to entail major time and effort.

This smooth, automated process has effectively eradicated debit balances. As a result, the group saved around AED 3m (£500,000) in interest payments over a year, a very substantial sum for the group.

Easa Saleh Al Gurg Group was named Small/Medium Treasury Team of the Year in the ACT Middle East Deals of the Year Awards in 2013.

Centralise

Multilateral netting needs a netting centre that acts as a counterparty to all the subsidiaries in the group. The netting centre is usually operated by the central or regional treasury centre. Using a netting centre, transactions are all recorded and then netted off. There is only a single net payment or receipt for each subsidiary.

Supplier payments

Third-party currency payables may also be included. Either the netting centre or the local subsidiary pays the third party locally, as paying agent for the group. The amount disbursed is then settled through the netting system.

This process is sometimes called POBO (payments on behalf of).

Customer receipts

External receipts are more tricky than payments. A recent assessment explored the practical problems.

Discuss the issues that may arise when a third party pays the money they owe one subsidiary into a group's multilateral netting system.

International Cash Management (CertICM), October 2014, Q4(d)

Where does the money go?

When a third party ('Customer C') pays the money it owes one subsidiary ('SupplierSub') into a group's multilateral netting system, the payment goes into a bank account owned by either:

(1) The group's in-house bank, if there is one; or
(2) A local subsidiary company that acts as a receiving agent for the domestic currency receipts of other group companies.

These accounts are then included in the multilateral netting system in the next netting cycle. These arrangements are sometimes known as COBO (collections on behalf of).

What's the problem?

Two major issues that arise with external customer receipts are:

(1) Indemnity; and
(2) Intercompany loans.

(1) Indemnity

A fundamental duty of a bank is to pay the person the bank's customer tells it to pay, and not someone else.

Continuing our example, Customer C needs to pay SupplierSub, the group company that supplied it with goods or services. SupplierSub is also known as the 'beneficiary'.

Problems can occur over the acceptability of Customer C's bank making a payment to an account that is not owned by the beneficiary SupplierSub.

In the UK, for example, banks may have a liability to Customer C for any funds 'incorrectly diverted' to a different bank account than that of the intended beneficiary.

In the UK, the banks would require an indemnity for 'incorrectly diverting funds to another account'. The group's indemnity obliges the group to reimburse the bank for any claims or losses that might occur. This was a knowledge gap for many recent candidates.

Incomplete answers

"Very few candidates gave full answers including issues of bank indemnities."

Examiner's Report, CertICM, October 2014

(2) Intercompany loans

A second issue can arise if too long a time passes between initial receipt of the funds and on-payment to the beneficiary SupplierSub, via the netting system.

Delayed payments to SupplierSub could be deemed to be interest-free intercompany loans from SupplierSub to other group companies.

This can create problems of interest allocation and withholding tax between the group companies. Therefore, groups that use these techniques tend to run their netting more frequently, despite the added cost of doing so.

Leave it out

Another potential issue with third-party receipts is reconciliation.

For these good reasons, external receivables are usually excluded from multilateral netting systems in practice.

Clean sweep

Turning to your studies, gather the learning material and practical insights into your net at an early stage, where they can be integrated. You can then identify any potential problems or knowledge gaps, and tackle them. Full and timely work will greatly improve efficiency and pay-offs.

Sweep as many learning opportunities as you can into the net, and enjoy the predictable benefits.

With many thanks to Michèle Allman-Ward for her much valued advice and guidance.

HELP FOR ACT STUDENTS

Download this and other useful study information from the student site you are assigned to: either the Resources area of the ACT Learning Academy at learning.treasurers.org or the Exam Tips area of the ACT Study Site at study.treasurers.org

Doug Williamson is a treasury tutor and finance coach. He enjoys seeing you net financial and time-saving benefits for your organisation and for yourself