

Multilateral Netting

[Copyright 1999 - Knowledge Management Applications - All Rights Reserved - Updated 1999-08-23](#)

Summary

Multilateral netting is a settlement mechanism used by companies to pay for goods and services purchased from affiliated companies. The netting process consolidates intercompany transactions and calculates settlement requirements internally instead of using external payment systems. Netting is typically used by companies with a number of affiliates in different countries. By netting, these companies reduce bank fees, currency conversion costs, bank balances, and improve operating efficiency.

A typical commercial transaction generates an invoice that represents a payable to the purchaser and receivable to the seller. The buyer settles the invoice on the agreed terms by making a payment to the account or mail location specified by the seller. The payment could be a check, an ACH credit, or an international foreign currency wire. The time, administrative costs, bank fees, and currency conversion costs associated with this process are a fundamental part of commerce. But when the same transaction occurs between affiliated companies, multilateral netting represents an opportunity to substantially reduce these costs.

In a netting arrangement, invoices from one affiliated company to another generate intercompany payables and receivables. Rather than settle the invoice by check or international wire the purchasing affiliate, selling affiliate, or both send a message to their netting center documenting the intercompany obligation. The netting center confirms this obligation along with others generated through intercompany trade.

The center converts the obligations to a common currency and calculates the net amount owed or due each affiliate after the settlement of all intercompany obligations. These amounts are then converted into the local currency of each affiliate which then pays or receives the net amount of its intercompany trade in its own currency.

Benefits

There are a number of benefits to multilateral netting. On the financial side, reducing the number of cross border flows saves bank charges and reduces the number of foreign exchange transactions and the spread lost to intermediaries.

Qualitatively, a netting system introduces discipline into the intercompany settlement process. Netting imposes clear time frames and terms on intercompany transactions, which allows for more rational leading and lagging of payments and avoids the negative tax impact of delayed settlements being deemed loans by tax authorities. A reasonable degree of certainty on settlements also helps to improve cash flow forecasting.

Multilateral netting is popular because it does not involve any changes in organization or invoicing. But netting doesn't do everything. It does not change FX exposures, it simply helps manage their settlement. And it does not change the tax liabilities associated with the intercompany transactions or address structural deficiencies or efficiency of the business organization.

Weblinks

[Auros Netting](#), [Coprocess SA](#), and [EuroNetting](#) provide netting systems and consulting services.

[Bank Mendes Gans](#) and [Bank of Tokyo Mitsubishi](#) are commercial banks offering a complete multilateral netting service.

Contact [Global Cash Management Ltd](#)

Netting Cycle

Netting is a process which follows a regular cycle and also involves a netting system which enables the process to run smoothly. The netting cycle begins (step one) when company affiliates, generally referred to as netting participants, send notification to a netting center of their intercompany obligations. This notification can be a batch process which takes place monthly or a continuous activity throughout the netting cycle. The exact form of the notification will depend on the type of netting system used.

Participants can notify the center of intercompany purchases, sales, or both. Purchase notification only is generally referred to as a payables driven process and sales notification is referred to as receivables driven. In theory there should be no difference between the two but most companies use a payables driven system to reduce reconciliation problems at the next step in the netting cycle.

This next step is for the netting center to confirm all obligations (step two.) Notifications received after this confirmation are deferred to the next cycle. With all intercompany obligations confirmed, the netting center obtains a set of indicative exchange rates (step three) for all of the currencies used by the netting participants against a common currency, such as the Euro or the U.S. dollar. These rates are the indicative rates at which the center will buy and sell the currencies and are obtained from an information terminal such as Reuters, a bank, or an fx broker.

The indicative rates have two important characteristics. The first is that the buy and sell rates are identical, there is no spread between the two. The traditional profit from spread on a sale or purchase of foreign exchange is retained entirely by the company – one of the major financial benefits of netting. The second is that these rates are indicative rates, good approximations of the market but not dealing rates. This means that there will be some variance between the indicative rate used for calculating the initial conversion and the market rate used to determine actual settlement amounts.

Using the indicative rates, the netting center expresses all of the intercompany obligations (step four) in a common currency and adds all payments and subtracts all receipts for each participant into a single payment or receipt. The amount is then expressed in the local currency of the participant, typically as a net payment or a net receipt. (In special cases the center separates this amount into a gross amount payable and a gross amount receivable.)

The center then advises each participant (step five) of their approximate position with the netting center and a date on which the exact amount will be determined. In most situations the netting cycle is monthly and the manager of the netting center publishes a calendar in advance with significant dates for all netting participants.

The center now determines the amounts of various currencies (step six) it will require to ensure that all obligations are settled. This is a different view of foreign exchange than the one the center took with the indicative rates. The indicative rates helped the center determine the amount that each participant would pay or receive in its local currency. In this round the center needs to buy and sell certain currencies which will be “left over” because some participants purchase more internally than they sell internally.

With the amounts in hand, the center contacts a bank or group of banks (step seven) and buys or sells its currency shortfall or surplus. This trading is generally done on a spot basis with the deal being awarded solely on low price. This focus on price is another major financial benefit of netting. Because not only is the center trading a smaller amount of currency (thus losing less spread to the market) but the center is also conducting the residual trading on commodity terms.

The center then uses the rates obtained in its dealing and applies (step eight) these rates to each participants' obligations – in place of the indicative rates used earlier. The new amount is communicated (step nine) to each participant along with instructions on where and when to send their net payment or where to expect their net receipt. Typically this communication has already been scheduled well in advance by the netting manager and also typically the accounts used by the netting center and the netting participants are well known.

Settlement (step ten) is usually two days from the communication date and reflects the fact that the netting center has dealt the currencies on a spot basis. The settlement date corresponds with the payment due date in a traditional third-party transaction and is one of the reasons that the bulk of multilateral netting takes place within the same company. The benefits of multilateral netting can be extended if the netting center can handle third-party payments on behalf of netting participants. In this case the participant settles his third-party obligation with the center on the settlement date and the center makes the payment on their behalf. Netting centers can also help participants with ad hoc foreign exchange requirements by allowing participants to offer or purchase currency to or from the center with settlement on the settlement day.

With settlement complete, the netting cycle begins again.

Netting System

Companies can outsource netting to a bank or other third party or perform the process themselves. Netting software by itself tends to be fairly simple and is offered for sale by reputable vendors. However the administration and integration associated with netting adds an additional burden to the software acquisition cost - a burden many companies choose to outsource.

Companies that manage the process themselves use remote systems that run on a mainframe managed by a bank or other third party. They can also use PC based systems installed on their own network. Companies using an outside processor have affiliates send details of their intercompany obligations to the processor which performs the netting calculations, handles the foreign exchange and manages the settlements.

Multilateral Netting

Terms and Conditions of Use - The copyright of this document is owned by Knowledge Management Applications. You may display this document on a computer screen, print the entire document on paper, email the document to others, and store the document in electronic form on disk on any server or other storage device connected to a network for your personal use. You may not modify, extract pages, or in any way commercially exploit the document. The document is for your general information and does not constitute any form of advice, recommendation, or arrangement by Knowledge Management Applications. The information in this document is provided "as is" and there is no guarantee as to accuracy, completeness, or fitness for your use. The document contains direct links to sites on the World Wide Web. These sites are provided and maintained by others and your use of these links constitutes your acceptance of each site's terms and conditions of use. Your use of this document constitutes your acceptance of these conditions.