

How to complement FX
strategies with liquidity
and multi-currency
management





An uncertain global business environment makes effective liquidity management and FX hedging increasingly important to provide funding stability and cost optimization.

The combination of rising interest rates and volatile stock market valuations creates a demanding debt funding environment. Many corporates have built up significant cash surpluses in the loose credit conditions post-2008. However, for multinational corporations, these are often held out of clear sight in idle balances held across fragmented global accounts.

It is estimated that global multinationals tend to hold at least 30% of liquidity in idle cash.¹ By running an effective liquidity structure, treasury can free-up these surpluses and leverage them to reduce reliance on short-term debt. After all, internal cash is the cheapest source of funding a company has. By freeing up capital and any other liquid cash reserves, companies have more freedom to target acquisitions, enter new markets and drive shareholder value.

Building on the three strategies to optimize liquidity and multi-currency management, here we introduce three key considerations and look at how these may complement FX hedging and exposure management:

1 | Multi-currency notional pooling

2 | Intercompany position management

3 | Negative yield optimization

1

Automate and optimize funding with multi-currency notional pooling

Cash pooling seeks to centralize multiple bank accounts in an effort to reduce idle balances and overdraft deficits. Notional pooling can achieve this goal by providing an ability to notionally offset surplus and deficit accounts. In this approach, the bank provider aggregates credit and debit demand deposit balances as a single cash position without any physical funds transfer. This technique can be particularly beneficial for treasuries looking to efficiently manage numerous accounts in multiple currencies, whether as a single legal entity or for multi-entity structures that do not create intercompany loans.

Account offsetting arrangements on which MCNP relies are not legally enforceable in all jurisdictions and notional pooling is, generally, only possible for freely convertible, fungible currencies. Multi-currency notional pooling is typically offered in the key financial centres of London, Singapore, Hong Kong and across Europe.

The fundamental liquidity management feature of this notional offsetting arrangement is that a treasurer can effectively leverage the idle balances of surplus accounts to self-fund a different currency account in the MCNP structure that is in deficit without needing to use intercompany loans and FX to hedge the resulting exposures. In this construct, the borrower's account deficit will simply create a liability against the pool in its base currency. When possible, this provides a potential elegant management solution to allow for automated funding of entities in fungible currencies when there are sufficient funds within the notional pool across participating accounts and currencies.

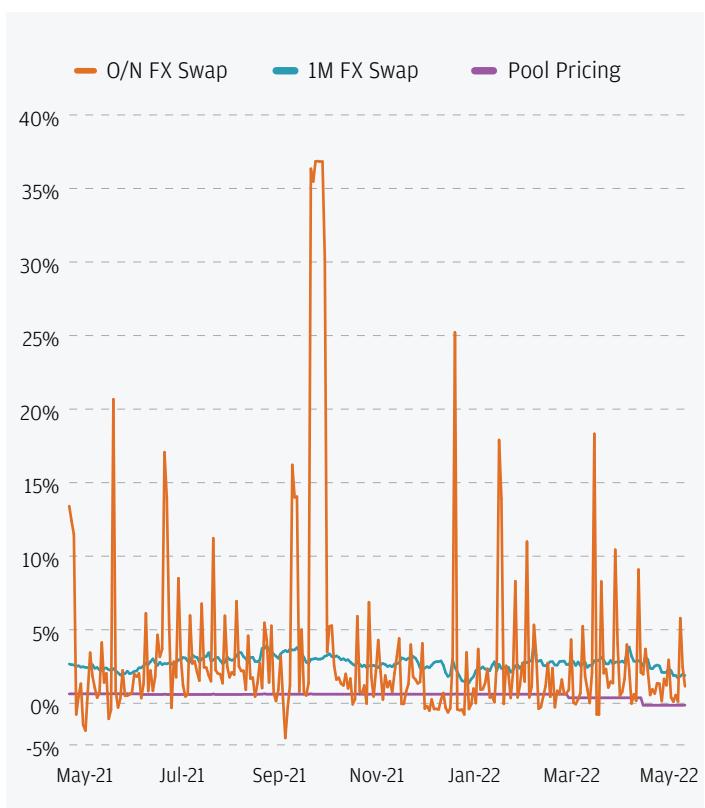
The pool approach can simplify working capital across a multi-currency ecosystem. It will not eliminate the need for physical currency conversion, inter-company loans and short-term credit that may require FX hedging; but it can reduce these activities and create cost-efficiencies with pricing that is more preferential on an overnight basis.

The potential to centralize liquidity and reduce loans and FX executions could have numerous additional benefits.

Price stability via the portfolio effect

A notional pool allows the set of demand deposits to be viewed as a single cash balance, thus creating a portfolio effect. The diversification benefit of a portfolio tends to reduce daily price volatility. Notional pooling can have the effect of replicating the economic effect of using overnight FX swaps to bring a set of currency exposures into a single currency position. This means that the portfolio effect of pooling could be observable by comparing daily pool prices with the alternative, overnight FX swaps market.

CNH - O/N 1 month Swap vs Pool Pricing



The swap time-series display selling CNH & buying USD, effectively lending CNH & borrowing USD. The pool prices represent an equivalent drawdown of USD against a long CNH position.

Source: Bloomberg

Pool price volatility is generally more closely correlated with typically less volatile longer tenor swaps. This provides greater stability and predictability to account balances, which assists forecasting and therefore facilitates greater accuracy in any FX hedging.

Cost optimization

Notional pool interest charges generally should provide both price stability in relation to O/N FX swaps and an interest spread tightening in relation to standard deposit rates. A bank can improve rates with notional pool pricing because there are cost savings associated with the practice. The arrangement of offsetting the corporate's account balances can create a net balance that could have the effect of reducing the bank's capital requirements under Basel III and other national stipulations. Any regulatory cost saving could potentially be shared with the corporate customer on a fair and equitable basis, effectively narrowing the bank spread.

Multi-currency notional pooling (MCNP) is a working capital treasury solution that provides real-time visibility with ready access in a single nominated currency to release idle cash and reduce liquidity buffers. This in turn provides an opportunity for the customer to reduce debt, improve the balance sheet; or to mobilize excess liquidity for alternative investment options.

There could also be an internal, operating cost saving created by using the notional pool to manage daily currency balances rather than using intercompany loans or O/N FX swaps. The notional pool has the potential to reduce the volatility risk exposure of potentially needing to enter the O/N FX swaps market for urgent funding at potentially high rates. The daily pool price may well not be lower than the equivalent swap rate, but the key customer benefits might be found in reduced workload and increased stability of operating and funding costs in contrast to the operationally demanding and price-volatile O/N swaps market.

Balance visibility and flexibility

Notional pooling provides a concentrated view of fragmented cash positions. The treasury receives real-time reporting of currency positions in the pool, effectively providing instant visibility of global liquidity. This could facilitate cashflow control and reduce potential forecasting errors, more accurately identifying FX risks and reducing the build-up of idle cash balances.

Improved visibility and forecast accuracy could translate into increased flexibility as it could allow a treasury to accumulate the correct amount of foreign currency for working capital needs. When that is achieved, any FX need only be made at the appropriate time to meet committed and forecast transactions. The need for urgent, short-term foreign currency funding at uncertain FX rates should be significantly reduced.

As the cash pooling is notional, centralization does not impact the underlying balances or net investment exposures. Participating subsidiaries, for example, may continue to hold their own currency as part of a multi-entity pool. Any entity needing to drawdown an amount of currency from the pool can do so, provided it is available, creating a liability against the pool. No FX should be required and there may be no change in balance sheet exposure.

Foreign exchange activity could also be reduced because pooling has the effect of cutting down the need to tap internal, foreign currency funding using intercompany loans with their associated FX risk and operational cost. But it does not eliminate this approach. Multi-nationals will typically need a hybrid, layered approach using both the pool and intercompany loans with an associated FX hedge programme, especially when tapping into the more restricted markets.

The notional pool simply shifts the typical focus of an FX hedge strategy further out to longer tenors. This makes notional pooling the short-duration bucket of a hybrid solution. The flexibility of the pool arrangement can remove the need to use O/N swaps for unforeseen short-term liquidity and allows Treasury to focus on forecast, larger size, strategic use of FX swaps.

2

Enhance cash extraction by optimizing intercompany position management

A global multi-national company will inevitably have some cashflows in restricted currencies. These cannot usually be freely, actively managed via a notional pool.

A build-up of restricted currency cash will typically need to be converted into the pool's base, major currency before extraction via an intercompany loan. The idle balance can then be brought into the pool and the participant account will have a foreign currency exposure that may need hedging. Idle cash balances can be managed on an automated basis with an overlay structure using the bank's automated FX cash concentration tools.

Structural idle balances in a pool currency may also be better managed via an intercompany loan that may require an FX hedge. Similarly, an entity that is forecast to be a net borrower for many months, may be more economically funded by a hedged foreign currency loan than by leveraging the notional pool.

There may also be funding requirements in these restricted markets. Similar automated cross-currency tools can facilitate the injection of funds into the markets from a notional pool or a central funding account. This can provide central control of funds and could enhance visibility of intercompany positions - especially when used in conjunction with virtual solutions such as virtual

accounts, where permissible. FX exposures can also then be centralized through the notional pool and the central treasury organization.

Some markets allow for an intercompany loan to be made available in the restricted currency. This could allow for FX exposure and management to be centralized with the treasury entity. In other markets where only USD or another foreign currency is available, while the exposure remains with the local entity, the FX hedging could be 'handed over' to the central treasury entity with consent of the regulator. Both approaches can create cost efficiencies due to either the centralization of the actual exposure or the FX management activity itself.

Similar strategies can be deployed to automate trade related fund flows, providing resilience not only for treasury flows but also for the entire intercompany ecosystem.



3 | Negative Yield Optimization

It is important to keep in mind the currency of the intercompany relationship and the currency being funded or extracted.

Currency balances in a notional pool that attract a negative or zero deposit rate can be managed via an automated target balancing tool. Individual accounts within a notional pool can be run in deficit provided the overall pool remains zero or net positive.

This can be done manually or by using the same automated cross-sweeping tool that is commonly used to move out restricted currency balances. This approach could facilitate natural business cash inflows to build-up until the account reaches the zero-balance level, which could then trigger a conversion to a currency of choice. It could also mean that the entity might have the ability to continue to pay in the negative-yielding currency without needing to hold a positive balance.

Such an approach has the potential to avoid negative interest charges and convert the exposure into a currency attracting positive interest income. Although the USD is typically used for negative yield optimization (NYO) strategies, a company could use other currencies, especially if it is well-known to them and optimal from a balance sheet perspective. In this way, a treasury might have the ability to pro-actively manage their currency mix, providing greater control and flexibility.

We observe that corporates, where the bought positive yielding currency is the functional, balance sheet currency,

sometimes achieve limited to no FX exposure and the costs of NYO can be limited solely to the conversion. By converting into the functional currency, the corporate can potentially optimize the balance sheet by removing translation risk.

If the positive yielding account is in a different currency, this might create FX exposure. The need to manage that risk via FX hedging depends on numerous factors, particularly the customer's corporate structure and view of translation and balance sheet hedges. Alternatively, negative yield optimization might simply involve changing payment terms to pay almost immediately when receiving an invoice in a negative yielding currency. Of course, this would seem logical only when the company is cash rich as otherwise valuable liquidity would become unavailable.

Allow for scale and future-proof

It is becoming far harder for treasury departments to ensure that there is immediate access to liquidity and that there is always sufficient cash to run the business and make its daily working capital payments. This is especially important for large companies with complex structures that might be managing multiple currencies around the globe. The opportunity cost of not leveraging internal cash resources is that alternative sources of funding will have to be found, which can be more expensive.

By centralizing funds and using strategies such as multi-currency notional pooling, optimizing intercompany position management and NYO, companies might have an opportunity to release idle cash and reduce the need for less cost-efficient, short tenor FX solutions. The result could be real-time visibility and access to a stable source of cash in a single nominated currency that otherwise would be sitting idle.

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¹. Idle cash is the proportion of cash that is idle or restricted due to local capital buffers. Figure estimated using proprietary information.

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