RBS The Royal Bank of Scotland

Guide to Trading Internationally

Cash management

What's in this section?

The aims of this section are to:

- define cash management and briefly explain its objectives
- show how current assets can be safely converted to cash
- explain cash flow, short and long term receivables, liabilities and investment decisions
- briefly summarise foreign exchange markets, rates, spot and forward rates, discounts and premiums and foreign exchange exposure, currency options and futures, FRAs
- explain the need to choose the right banks and the need for daily management reporting
- enable readers to be less apprehensive of the subject through familiarity with the terminology and some of the more common products.

Definition and objectives

In simple terms, cash management may be defined as a management tool to ensure that sufficient cash is available to meet current and future liabilities, with any surplus being safely invested to generate the maximum income.

In practice, the way a company will tackle cash management depends upon its individual circumstances. There are a multitude of financial instruments by which a company can raise money, invest cash or hedge exposures. The company should be wary of financial instruments that do not suit their level of expertise, or do not match the fluctuating nature of the cash flow or the nature of their core business.

In larger companies, cash management may be the responsibility of a specialist "treasury team"; in smaller companies, the responsibility may be with a single finance director. In either case, there will need to be supporting staff with the necessary skills to help make informed decisions and make them quickly, correctly and without ensuing loss.

The overall objectives of cash management are to:

- maximise profit
- control liquidity
- minimise risk.

A smaller trading company within the UK will have more clear-cut decisions to make on its own initiative and responsibility than a larger company trading within and outside the UK with offices located in strategic foreign market locations.

Raising funds

The smaller company may tend to raise funds by either equity issues or bank borrowings, and invest cash surpluses in the UK money market and government securities.

The larger, more sophisticated company may issue corporate bonds in addition to equity or bank borrowings.

Current assets/debtor receivables: Irrespective of size trading companies would have 'debtor receivables', which can be quickly and safely converted to cash as shown below:

1. Invoice discounting: Banks may lend up to 50-85% of the value of trade debtors. In such cases, banks frequently take a direct charge over the invoice debt. Similarly, banks may lend on international trade debtors, provided up-to-date and satisfactory bank and credit agency reports are available on country and customer risk. Amounts paid by banks would also depend on whether credit insurance on the buyer was held. The money paid may in certain circumstances be without recourse on the trading company.
2. Forfaiting: Here banks may be willing to pay against a bill of exchange accepted by the buyer and guaranteed by the buyer's bank by 'avalisation'. No credit insurance is required and the trading company may receive a 100% cash advance from the bank on a 'without recourse' basis.
3. Factoring: A trading company may be able to raise cash by selling sales invoices at a discount to a factoring company. The factoring company takes over the trade debt; the payment would be on a 'without recourse' basis where there is credit insurance on the buyer and may be with recourse in the absence of such insurance.

There are other avenues, such as bankers' acceptances, which also provide liquid funds.

The above are examples of safe methods of turning receivables into cash, which could be a great advantage to cash management.

Cash flow

It is important that the mechanics in determining cash flow, both in the short term and in the medium term, are properly audited and verified so that there is a justifiable level of certainty about the figures reported. Online banking makes it relatively straightforward to ascertain up-to-date balances on all accounts in all currencies on a daily basis. In the case of large companies and multinationals, it may be possible to have the trading arms reporting in daily, not only balances, but financial trends and forecasts in their centres. It is more difficult, of course, to verify receipt of debtor receivables and to chase overdue debtor receivables. This is something that must be handled with great care, usually by the appropriate senior relationship managers.

Whatever internal systems are in place, it is essential that they have the necessary level of verification and certainty, without which cash management cannot work.

Payment of short term liabilities such as wages and other overheads and the **settlement of receivables** must be known and verified so that continuing liquidity is maintained.

Long-term liquidity includes such matters as acquisition funds, capital expenditure, pension provisions and the repayment of long-term bank finance.

Investment decisions: in considering investment, regard must be had for the trading objectives and company policy. Cash management is the by product of the day-to-day, month-to-month, year-to-year trading of the company. It would be foolish to indulge in speculative dealing which is outside the norms of the basic company business simply for the sake of short-term profit. An excess of dealing may be construed as speculation and not cash management.

Investment of surplus funds should be in the most tax-effective short-term investment instruments, based on the fundamental principles of safety and liquidity. (While bank deposits give a better return than current accounts, larger amounts (generally marketable amounts of £50,000 and over) should be placed through the bank's money market operations.)

Cross-border investment would need the additional considerations of the effective tax rates in each country to be taken into account. Statutory accounting rules applicable in each country must be respected so as not to violate any local reporting requirements.

It would also be necessary to get some information on credit risk; the global rating agencies such as Standard and Poor's and Moody's may be of assistance here.

A note of caution

International banks with their worldwide network of expertise in cross-border funding and investment are well equipped to assist businesses of all sizes with their expertise/connections and advice. It would be foolish to go in for cross-border investment for larger amounts and certainly for the longer term without researching all avenues of information and help available in the financial markets.

Foreign Exchange Markets

Trading in international markets means that trading companies have to deal with the risks of currency exposure. It is therefore necessary for the cash management team to have an overview of the foreign exchange market and at least an elementary knowledge of some terminology in use.

The market

The foreign exchange market has no physical form in the sense that there is no actual marketplace where currency dealers meet; the market exists through the most sophisticated communication networks. The leading players are London, New York, Frankfurt and the other centres in the Far East such as Tokyo, Hong Kong and Singapore.

The need for the market arose when a buyer of goods paid in the currency of their own country and the seller had to receive funds in the currency of the seller's country; therefore the need was and is to change the value of one currency into the equivalent value in another currency.

The **rates** at which one currency converts to its equivalent value in another currency depends upon the demand and supply of each of the currencies being converted.

There are short-term and long-term factors affecting the supply and demand of currencies.

Short-term factors include commercial operations such as paying for goods and financial operations in stock exchanges, banking, speculative transactions, interest and loan repayments, and inter-governmental transfers.

A rate of exchange is therefore the price of one currency in terms of another; rates are quoted in two ways:

1. A variable number of units of foreign currency to a fixed number of units of home currency: e.g. euro 1.4640 = £1; or Hong Kong dollars 14.14.4531= £1. This type of rate quotation is termed an "indirect rate".
2. A number of units of home currency to one unit of overseas currency: e.g. quotations in euros are quoted to one unit of overseas currency. This type of quotation is termed a "direct rate".

Buy High Sell Low: Banks normally quote two rates of exchange – one is the buying rate and the other is the selling rate; banks take their profit on the difference between the two rates, i.e. on the 'turn'. If for example the rates quoted for the US dollar are 1.8625 and 1.8635 [i.e. £1 = USD 1.8625 to £1 = USD 1.8635] the bank will buy US dollars at 1.8635 giving less sterling; it will sell US dollars at 1.8625 giving less US dollars to the pound.

A **Spot rate** is the rate of exchange for a foreign currency transaction which is to be settled within two working days of agreeing the rate.

It is the market rate on the day the rate is agreed; it should be noted that the spot rate of exchange can fluctuate quite dramatically from day to day and therefore for continuing trade it is not a basis upon which to work.

A **Forward rate** is a rate of exchange which is fixed '**now**' for a deal which will take place at a fixed date or between two days in the future.

A **Fixed Forward contract** is where the future date at which the transaction will take place is fixed.

An **Option Forward contract** is where the time at which the transaction will take place is any time within a specified period.

Discounts & Premiums: rates for forward exchange deals are quoted as so much premium or discount on the spot rate.

When a forward currency is more valuable than the spot currency, the forward is said to be at a **Premium**.

When a forward currency is less valuable than the spot currency, the forward is said to be at a **Discount**.

Premium means **forward** is **dearer** than **spot**.

Discount means **forward** is **cheaper** than **spot**.

The prime purpose of forward exchange is to eliminate risks of loss arising from fluctuations in foreign exchange rates as shown in simple terms below.

An importing company in the UK, for example, may have to pay a series of trade bills in US dollars during a period between two set future dates. As the spot daily rate may fluctuate against sterling between now and the future period, by entering into a forward deal the trader has fixed the amount of sterling that will be needed to settle the payment.

Similarly, for an exporting company expecting to receive US dollar receivables at a determinable time in the future, by entering into a forward deal to convert the US dollars to be received, the exporting company knows how much sterling will be received. The downside of this arrangement is that if the importing trading company does not have sterling to pay on the dates in the deal or does not want to do so for one reason or another, there will be a penalty for not taking up the deal; there will be a similar penalty for the exporting company if the anticipated US dollars are not received and the deal is not taken up.

A **foreign currency option** is an agreement whereby the customer can pay a premium to the bank for the right – but **not the obligation** – to buy from or sell to the bank a specified amount of foreign currency at an agreed rate of exchange.

The option is with the customer, who can either exercise the right to buy or sell the currency at the agreed rate if the market rates move against him/her, or not exercise the option and allow the option to lapse in circumstances where the day's spot rate is very much in favour of the customer. The premium for the option has been paid upfront.

A **currency future** is a binding obligation to buy or sell a particular currency against another at a designated rate of exchange at a specified future date. All financial futures' contracts are standardised and only the rate of exchange is negotiable.

Foreign Currency Exposure

Foreign Exchange markets, products, market terminology and their fundamental meanings have been described previously.

It is now necessary to define what is meant by foreign exchange exposure and to describe the three main categories of risk.

Foreign currency exposure is the danger to a company following the need to **change its profit and loss and balance sheet position as a result of exchange rate movements. These are exchange rate movements** connected with any currency trade different from the home currency in which company's accounts are published.

This exposure can be classified in the following three categories: **Transaction**, **Translation** and **Economic**.

Transaction exposure

This arises where costs in currency A are matched by receivables in currency B; a UK company incurs costs in sterling to produce their product and sells it in the US in US dollars. (See also the positions of the import and export companies in Foreign Exchange Markets.)
The most common methods used to hedge transaction exposure are:
- netting/matching
- spot foreign exchange
- forward foreign exchange
- currency options.

Netting & Matching
Larger companies trading internationally are likely to have costs and revenues in foreign currencies. The treasury team should identify these items and net them against each other and look to hedge only the residual amount i.e. profit.

In cases where costs and revenues have a time lag – a foreign currency loan could be taken out to pay costs as and when they occur and the loan repaid from revenues when they materialise – again, the residue can be hedged. The cost of any borrowings should be recouped from the selling price.

Spot Foreign Exchange
In this case, currency exposures are only converted as and when they arise, and where there is a serious possibility of a weakening of the currency in which the product has been priced, there would be an adverse impact on the balance sheet. This can be hedged quite effectively by forward foreign exchange.

Forward Foreign Exchange
Hedging risk this way can conveniently cover receivables up to six months, so profitability can be locked in.

Foreign Currency options
This instrument envisages the payment of an upfront premium by the company, which gives it the right but **not the obligation** to purchase or sell a currency at a **guaranteed price. The option is with the customer**. If the rates move against the customer, they can take up the option for which they have paid; if the rates move significantly **in their favour, they can opt not to take up the currency option and trade in the market**.

Translation exposure

This occurs, for example, when the overseas assets and liabilities of the company change in value, in terms of the home reporting currency, from one balance sheet date to the next. An example of this would be a UK company which purchases a US company.

Specialist advice is needed in the correction or reduction of translation exposure.

Economic exposure

Factors affecting this are:
- the structure of the business
- currency of competitors
- the way in which costs and prices respond to change.

Some of these are outside the control of businesses but the following would help a company to meet adverse economic exposure:

- a high level of efficiency and profitability
- diversification of suppliers products and markets
- willingness to change manufacturing locations to reduce costs in the long term
- research into new products and new methods of manufacture.

All the above issues are fundamental as is the constant need to review business plans and methods, and be constantly alert to external changes.

Finally, there is interest rate exposure and unhedged interest risk can be as costly as unhedged currency risk. Borrowing costs, whether in sterling or currency, can be hedged by fixed rate loans, Forward Rate Agreements (FRAs), interest rate swaps and currency swaps.

- Fixed rate loans are self-explanatory and the borrower would not be disadvantaged by rising interest rates.
- FRAs do not provide funds in themselves but guarantee the cost of funding.
- Interest rate swaps allow current debt on fluctuating interest rates to be swapped for fixed interest debt.
- Currency swaps are flexible and long term; if a company has long-term cash flow in US dollars it can ask its bank to receive sterling; the concept is much more flexible and can be tailored to meet exact requirements.

Choosing the right banks

Banking relationships must be reviewed regularly to ensure that banks are selected by their product knowledge and their proven practical expertise in fields important to your business. Financial charges must be reviewed with a view to constantly containing them.

Note

1. International Banks in the UK are highly regulated and are publicly answerable for most if not all of their actions.
2. These banks are very well qualified and able to advise trading companies exactly how any foreign exposure/risk can be minimised and they will readily do so.
3. What the management of the trading company has to do is understand the business of the company thoroughly and explain it to the bank, who will then not only be able to devise the best method of minimising risk, but will also be able to spot risks of which the trading company has not been previously aware.
4. In the field of foreign exchange risk, the trading company is well advised to be guided by an international bank, and personal relationships, both at board level and operational level, must be carefully nurtured.

Management Reporting

As in all other aspects of trading, it is important to keep senior management aware on a daily basis of:

- liquidity issues
- large payments that have to be met
- large receivables coming in (foreign currency receivables and payments)
- conversion of trade receivables into cash
- the extent of any borrowing on overdraft and loan
- losses accrued and other losses
- assessment of customer credit, standing and continuing contact
- control of country risk and buyer limits
- foreign exchange exposure and hedging.

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