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TRANSCRIPT

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Utilizing Notional Pooling and FX Netting to Drive Down Operating Costs

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Coordinator

Hello and welcome to the Bank of America 2021 Global Liquidity Speaker Series for Utilizing Notional Pooling and FX Netting to Drive Down Operating Costs. My name is Lisa and I'm your event manager. During the presentation the lines will be on listen-only. [Operator instructions]. I'd like to advise all parties that the conference today is being recorded.

And now I'd like to hand the call over to your host, Warren Bolton. Please go ahead.

Warren

Thank you, Lisa, and a very warm welcome, and good morning and good afternoon to everyone. Welcome to today's liquidity series discussion. The agenda for today's topics will be starting with notional pooling. Then we will look to move on to FX and netting and we'll look to share some ideas with you on how best to minimize costs and to maximize efficiency.

Let's move on without any further delay and give you an update on notional pooling. So without trying to sound too basic about the actual structures and what pooling is, notional pooling, in its simplest terms, is the ability to offset short and long positions. Those short and long positions can either be offset in a single currency or they can be offset across multiple currencies, whereby you would notionally convert balances in the different currencies to a base currency so that you have a single position across each of those participating currencies to understand what the position of any pool would be.

Firstly, when it comes to constructing a notional pool you need to choose a location of choice. The preferred choice of location will depend where in the world you're based. When it comes to EMEA, the long established pooling locations have traditionally been London and Amsterdam, although of late we have also seen quite a few new jurisdictions entering the market.

And I guess the major difference between those and the established ones will come back to the double taxation treaties, which are London and Amsterdam, certainly have the primary driver over. When we look at the other parts of the world that also employ notional pooling, or certainly allow notional pooling, we're looking at places like Australia, Hong Kong, and Singapore, as in Asia Pacific.

A lot of the notional pooling is driven by the regulations within the respective jurisdiction, so this is why notional pooling isn't available in every jurisdiction around the world. And it needs to be understood by the local regulator, the local central bank, and supported by the financial industry there in turn.

When it comes to creating the notional pool, once you've decided upon your location you would also need to then understand whether or not you would wish to run the notional pool operating as a single entity, or whether it would be a multiple entity notional pool. The difference between the two is quite simply if you're operating a single notional pooling structure, then that single entity is most likely to be a treasury-driven entity, whereby you would look to consolidate all of the balances from the group at the treasury entity level and then across the multiple currencies that the treasury would operate they would wrap that up as part of a multi-currency pool.

However, if the single entity wasn't appropriate because the participants in a multi-currency pool by multiple entities required for the multiple entities to have autonomy over their own balances, then this is where the multi-entity pool would take precedent. So this would allow for each entity to participate within a pool, it would have full autonomy over its balances within that pool and there would be no commingling of funds, which is very important, as one of the constructs of the notional pool is really to try and avoid intercompany lending arrangements where at all possible.

So depending on the approach of having that single or multi-entity notional pool, the first element that needs to be addressed once the location has been decided upon is how to get the funds from the participating jurisdiction to the centralized location. Because it needs to be clear that the notional pool needs to be centred on one central location, it cannot be over multiple jurisdictions.

So in order to address this, you really need to start by having a degree of cash concentration which wouldn't physically move funds and entities' balances cross-border to the centralized location. This would require any participating entity to open up a mirror account, which would be a non-resident account, at the pooling centre, and this would allow them to therefore participate in the notional pool. Their balances would also contribute to the aggregate balance of the pool, and any of the long balances that were brought into the pool would also help to mitigate some of the very short positions from the jurisdiction, and therefore achieve the reduction in debit interest, which is the primary element of running the notional pool in the first place.

But as we look at the ability to bring the individual balances of all of the participants to a central location, once they are at the central location then you have the ability to choose a base currency. And that base currency is simply there so that when there is a virtual or a notional conversion from the respective currency that is participating, and if we were to say, for example, in Europe that we were using a base currency of euros, if participating currencies in sterling, dollars, Polish zloty, or Swedish krona were within the pool there would be a notional conversion from those currencies to arrive at a euro equivalent. And therefore, you could aggregate the individual positions to a euro base, and that net position across all of those balances would give you that single position in euros.

The one aim of the pool would be to always have 100% coverage, and by that we mean that the long balances will always exceed the short balances. And therefore that's where the benefit would be returned to you in terms of the reduction in debit interest which would be accrued from those short positions.

Other considerations that should be thought about when setting up the single entity versus the multi-entity pooling arrangements is with the multi-entity notional pool you would have to have cross guarantees set up for each of the individual parties that participate within the pool. And this is effectively enabling the banks to offset the positions between the participating entities, but also it ensures that should something happen to one of the participating entities, then any short positions when something happens can be covered by the longer positions across the remaining entities within the pool.

So slightly different to how a physical cash concentration works, which were typically as the individual participant counts zero balance there. But it is important that all of the balances are located at the central location and therefore all of these can be offset accordingly. Importantly, there is no intercompany loans created within the pool, and that's important for the participating accounts. It ensures that the autonomy of those balances remain with the participant.

But also when we look at the overall construct of the pool, and as we talk about the benefits from the cost savings from debit interest, when it comes to returning the net benefit of those debit interest reductions back to the notional pool participant, it needs to be passed back in what is a very transparent way. Typically, a lot of the benefit has been passed back to a nominated pool leader, but there are options whereby the benefit can also be passed back to the individual participant at the base on a percentage, an equal split, or it can be done on a contribution base.

As there's more reviews going on by the OECD regarding debt and the first pillar and soon to pillar two coming into focus during the quarter of 2021, the transfer pricing is very much front and centre for the authorities. So it's very important when constructing a notional pool and returning any benefit to its participant that it does adhere to these very important pillars because these will have a major impact for future accounting positions.

At this point I'm just going to do an introduction to my colleague, Elizabeth, who will take us through the FX and netting as the next part of the agenda. But what's important from a notional pooling perspective, and it also touches on the FX and netting, is very much around the jurisdictional elements of the notional pooling participant. Not every jurisdiction has a legal right of opinion in order to participate within the pool, and the same can be said also for netting as well.

And I will use this opportunity now to pass over to Elizabeth, who will take you through some FX and netting overviews as well. Elizabeth?

Elizabeth

Sure. Thanks, Warren. Good morning and good afternoon, everyone. We tend to pair pooling and netting together, and that's really because if it makes sense for an organisation to explore pooling it also makes sense to have a discussion on netting as well.

While notional pooling is about interest rate optimization, multi-currency netting is really a transactional solution designed to streamline the intercompany settlements that take place within the company. Without a netting program, various global entities will make intercompany payment to related entities in different currencies on different timelines, and so all of those payments occur kind of ad hoc, either as needed or based on their different payment terms.

With a netting program, the company establishes a netting centre entity, which essentially serves as a clearinghouse for all of the intercompany AR and AP. And typically the jurisdiction of that netting centre is similar to where you would house your pool, you know, the UK, Ireland, Amsterdam are the most common jurisdictions that we see.

Every global legal entity that is included in the netting program is called a participant. What the participants do is they submit all of their intercompany transactions to the netting centre, which then analyses all of those flows to determine a single payment or receipt per participant in that participant's home currency.

So instead of each legal entity making multiple intercompany payments, they only have one single payment or receipt in their own currency. And this process is run regularly, usually monthly, to clear all of the intercompany AR and AP.
Why establish netting? It's about creating a routine around these transactions, providing full visibility into those flows. It demands regular settlement, so you would have a more harmonized set of payment terms across the organisation. It's a centralised, efficient process to clear all of these transactions.

And it leads to cost savings, right? So because you're reducing the number of payments that you have to initiate, track, settle, reconcile, there's cost savings that come along with that. When we work with clients, we help to quantify what is that reduction in the number of payments that you have to make, and typically it's in the 70% to 90% range. So a really meaningful reduction in how many payments you actually need to execute each period.

There's additional cost savings because you're reducing your FX exposure. Essentially what you're doing is taking all of the intercompany exposure that your legal entities face and aggregating it with the netting centre entity. You fully utilize any natural hedges that exist within the company when you run that netting analysis and so you end up trading a much reduced FX notional amount, and that produces the cost savings that I referenced.

When we run this analysis for clients, that notional reduction is typically in the 60% to 80% range. So again, a very meaningful reduction in the FX amount traded when you move from a gross intercompany settlement scheme to a net intercompany settlement scheme.

When you talk about the routine that you establish, the process, typically this is a very automated process for a company to administer. You couple that with cost savings, the other piece of savings is just time savings, right? Instead of having multiple potentially finance managers or treasury managers involved in again initiating tracking, reconciling all these intercompany payments, you've made it a much easier process to administer, much greater visibility. And that results in time savings typically for the treasury team or the shared service centre who is administering these payments.

One note, because Warren did bring this up, in terms of the participants, there are local regulations per jurisdiction that affect what countries can be included and what can't. And again, that's based on local currency restrictions as well as netting restrictions by the central bank and other local authorities.

And so at the outset you need to determine the scope of your program and look at, based on your footprint, what entities are eligible to participate in netting. That's part of the scoping exercise that would take place once you embark on establishing a netting program.
How does Bank of America support netting? We've developed a suite of solutions to support our clients' netting programs on an end-to-end basis. As you can imagine, there are plenty of banking solutions that are core to administering netting, right? You have netting centre accounts, payments FX. And that's a big piece of the picture, but the other piece is the netting administration.

And to help with netting administration, we've partnered with a market-leading netting software provider to deliver this capability to our clients, which means that we can provide a one-stop shop to gather your AR and AP, perform the netting analysis, book the FX trades, and execute the payments that come off of the back of your netting program. So a really powerful tool, and really speaks to the objective of netting, of automating your intercompany process and making it as streamlined as possible.

No matter where you are in the netting process, as you're embarking on an initial setup or you have a well-established program, we can take the different tools from our netting tool belt and plug in different ways to automate and streamline. Specifically, one solution that we work with clients on is what we call a guaranteed rate. A guaranteed rate is simply a spot rate that's held for a period of time, a spot FX rate that we hold. It's typically a couple hours up to a full day that we hold the guaranteed rate for when it comes to netting.

And what that allows companies to do is match the rate that you calculate your net positions on to the rate that you execute. So without a guarantee rate you're using two different rates. Your calculation rate could be a plug rate, an accounting rate, and just a bank rate that you pull at the moment that you're calculating versus your execution rate, which is a live rate. The mismatch between those two means that you could hold residual balances in your netting centre accounts or you could be asking your bank to amend the FX trades after they're booked.

So there is this nuisance step once you close your netting to go back and make those changes based on the final rate that you receive. We can clear all of that up with a guaranteed rate, again, because we're matching our calculation rate to your execution rate, it makes your FX execution process very smooth and eliminates a nuisance reconciliation step once the cycle is closed.

So with that, I will go ahead and wrap up a bit. Thank you, everyone, for the time this morning and this afternoon. I hope it was helpful to hear a quick overview of notional pooling and multi-currency netting. Certainly Bank of America is here to help if either of those solutions are of interest to you. Please feel free to reach out to your treasury sales officer to learn more.

I will give it back to Lisa to go ahead and close the call.

Coordinator	Thank you, Elizabeth. That concludes your conference for today. You may now disconnect. Thank you for joining and enjoy the rest of your day.

[END OF CALL]