Managing Cash Flow, Currency and Payment Risk
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As US companies look to expand or start new operations overseas, new risks emerge that must be managed, with cash flow, currency and payment among the most predominant. As Karen Gilhooly, SVP, Global Payments and Cash Management and Ivan Asensio, SVP, FX Risk Advisory at HSBC explain, while these risks can never be entirely eliminated, they can be managed.

Whether a US company is looking to extend existing overseas operations or to start their first overseas venture, the challenge is broadly the same. While a corporation that already has some existing foreign business units will have a head start at the conceptual level, when it comes to the day to day detail, both types of corporation have a set of new risks to manage. While they will have already encountered some of these risks domestically, they take on a completely new form when the financial infrastructure, business practices and regulations are unfamiliar.

Reality check: where you are and what you know
The most fundamental step in managing any risk is to be clear on its extent and implications, which in turn requires a reality check on the corporation’s ability to assess the extent of any risks accurately, as well as to manage them effectively.

At a high level, most corporations are well aware of the potential challenges of overseas expansion in general terms. However, even some sophisticated corporations underestimate the scale of the risks they will face and the variety of ways in which these risks can affect their business as a whole.
One of the most obvious examples of this situation is foreign exchange, where even large corporations with existing overseas operations still do not have large foreign exchange departments. In many cases, these departments will consist of one person, who probably also has other additional responsibilities.

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Even companies with substantial foreign exchange departments have difficulty in keeping abreast of all the continually shifting market paradigms. Factors such as central bank involvement completely alter the volatility dynamics, so keeping abreast of how this and other factors flow through into company financial statements for just existing overseas operations is challenge enough. When moving into new markets and having to deal with unfamiliar currencies, then the complexity level ratchets up yet still further. Decisions such as the functional currency choice for a new market have major ramifications for FX management and accounting. As a result, prudent treasurers and CFOs are pragmatic in their willingness to seek outside assistance.

Information and understanding: joining the global dots
For both FX and other risks, the crucial point is obviously seeking this assistance well in advance of any new overseas business going live. If the company is large enough to be using global accounting and legal firms already, then specific advice in these areas for many new markets should already be readily accessible. However, when it comes to cash flow, currency and payment risks, the sources of reliable guidance are far more restricted. The obvious port of call here is a bank, but domestic banks will obviously lack the necessary coverage and upon closer inspection most corporations will realize that most global banks offer far less than global coverage when it comes to physical presence. Those that really have a global footprint and can leverage this to provide the precise risk information that corporations actually need are extremely few and far between.

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The key point is that the provision of any information is done within the context of the corporation’s existing business model. Delivering a raft of detailed market information is of far less value if it has limited relevance to the way in which a corporation actually operates. Accomplishing this requires the bank to be able to connect local expertise from the client’s intended new overseas market(s) with the domestic US relationship. For example, a bank assisting a US corporation
considering a new manufacturing facility in the Philippines needs to have a clear understanding of the client’s objectives before engaging its local personnel in Asia. If it is able to brief these local personnel on the client’s background and intentions before introducing them to the client, then far more pertinent and valuable information can be provided.

**Risk mitigation: availability versus practicality**

Once clients have relevant guidance on the cash flow, currency and payment risks they are likely to encounter in a new market, they are able to make far more informed choices when picking the right tools for risk mitigation. However, as the pace of globalization has accelerated, the range of these tools has also expanded, as has their flexibility, so the best choice may not be obvious.

If one considers just the options available for managing payment risk, the range is extensive. At the most conservative end of the spectrum are traditional trade tools such as letters of credit (LCs), but there are a multitude of alternatives including factoring, invoice discounting and sales chain (distributor) financing that lie between LCs and the opposite extremity of open account trading. But picking a particular solution can have unexpected and negative consequences, even when at first glance it appears the safest.

While LCs (especially when confirmed by a reputable bank) offer the greatest security to the inexperienced seller in new markets, they may not always be the most appropriate solution. For instance, a bank with sufficient local expertise would be able to alert the client to situations where overseas buyers are likely to be resistant to issuing LCs and suggest an alternative solution. Without this sort of guidance, the corporation might inadvertently add the commercial risk of offending/detering potential buyers to the existing payment risk.

On the flip side, a corporation also has operational risks associated with its own payments that have to be managed. Maintaining a large number of local bank accounts has an obvious cost overhead, but it also increases the possibility of operational errors due to increased complexity of reconciliation and administration. One way of reducing the possibility of these errors is to eliminate low volume, non-strategic bank accounts and instead take advantage of a bank’s global payment network to make payments from the corporation’s current account in its primary currency. The bank then automatically translates these payments into the appropriate local currency equivalent and remits to the beneficiary. This approach effectively delivers a multi-currency payment strategy, but without the need to maintain multiple local currency.

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accounts. The corporation reduces its own risks and costs, while also maintaining commercial leverage with suppliers by paying in their local currency.

Managing FX risk raises similar challenges to managing customer payment risk. The past decade or so has seen an expansion in available hedging instruments for many overseas markets (including some high growth emerging ones) together with greater liquidity and transparency. With the exception of only a handful of markets, such as Venezuela, there are now hedging tools available for virtually every currency. Execution costs have also declined with the expansion of electronic trading, while dealing spreads are a fraction of what they were 20 years ago, and the quality of price discovery has also improved substantially.

One only has to look at a market such as China, which has seen tremendous growth in available risk management tools that are accessible to businesses both onshore and offshore. Today, in addition to the onshore spot/derivatives market and the non-deliverable market that have been available since the original currency peg was lifted in 2005, there is an offshore spot and derivative market (which means the renminbi is a convertible currency offshore for trade-related flows) settled in offshore centers such as Hong Kong, Taiwan, and Singapore. As with cash flow and payment risk, the mere availability of risk mitigation tools does not automatically guarantee their suitability. For US corporations, there is a direct clash between the logical economics of a hedging strategy and its implications in terms of accounting presentation. When a company is devising a hedging strategy it is essentially forecasting revenue and expenses, often over a range of timeframes, with the certainty of that forecasting diminishing as its tenor increases. That in itself is no easy task for many corporations. Nevertheless, armed with these forecasts it should be possible to construct a hedge with sufficient flexibility to cover the various eventualities. Unfortunately, in the absence of favorable hedge accounting treatment, this runs headlong into the issue of having to place that hedge on the balance sheet and then carry it at fair mark to market value in the income statement.

For longer term and larger forecasted exposures this can easily result in major P & L swings that are completely unacceptable from a market/investor perspective. As result, most corporate focus tends to fall on hedging short-term exposures that are already on the balance sheet, which will often be hedged using something like a forward contract and directly offset the booked exposure. While this approach minimizes P & L swings, it does nothing to protect future sales margins or the profitability of a new long-term

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project or investment. The crucial underlying point here is that a universal hedging solution cannot be achieved with a single strategy. A comprehensive risk management program typically involves collectively implementing a number of different strategies aimed at different objectives, such as:

- Protecting income statement swings from items already on the balance sheet
- Hedging forecasted but not yet booked cash flows
- Protecting the USD value of a net equity stake in foreign subsidiaries

Nevertheless, while the improving availability and flexibility of hedging tools is obviously valuable, it is important to note that they should ideally be the last resort when managing FX exposure. A less costly and more efficient alternative is to establish asset/liability matches so as to minimize the corporation’s net exposure to each foreign currency. For instance, supposing a US corporation is selling into Europe via a European subsidiary and earning Euros, thereby implicitly creating a long exposure to Euro weakness. An efficient way of minimizing this exposure (if commercially appropriate) would be for the subsidiary to take up a Euro-denominated borrowing facility or LC to offset the long exposure.

**Putting it all together**

Apart from a few very sophisticated corporations that already have extensive overseas operations and the resources and expertise to manage a “big bang” project in one go, less internationally experienced companies will find that a progressive approach to hedging exposures in new markets pays dividends. For instance, as regards cash flow and payment risk, the way in which the first new overseas subsidiary is incorporated into the corporation’s existing cash management solution will probably be very different from the tenth. This would be true at any time, but is especially so at present, due the pace of change in clearing infrastructure in many markets across regions such as Asia. One only has to look at China to appreciate how fluid the situation can be and the benefits of responding accordingly. There, the latest
iteration of the CNAPS domestic clearing system will enhance the nationwide payment infrastructure and the forthcoming China International Payment Platform (CIPS) will provide a new dedicated cross border payment link.

Nevertheless, this gradualism still needs to take place in the context of a long term strategy and the current trend in certain emerging markets of gradual regulatory liberalization. For instance, does the corporation ultimately intend to have a pan-Asian regional liquidity pool, or just in-country pooling? The wrong choice in the early stages can be messy and expensive to amend later. A current example of this is China where in order to satisfy regulation around the use of Basic Accounts some companies originally opted for what was then seen as the easy option of using local banks for these accounts. In practice it is perfectly feasible to use global banks for this purpose, which in view of the new opportunities for liquidity management emerging in China has left those who opted to use local banks at a significant disadvantage. This consolidation also reduces the operational risks of using multiple banks with different interfaces and communication protocols. Consolidating as many accounts as possible with a single provider and leveraging its liquidity tools also makes for more efficient management of cash positions and opens the door to higher returns.

An important consideration when minimizing overseas cash flow risks is that the necessary information is not automatically as accessible as in the US. Apart from possible delays associated with local banks, some clearing systems have limited free format capacity for remittance information and foreign language characters can also cause problems with domestically-oriented AR systems. Using a bank with a global footprint that includes an extensive local physical presence can alleviate a lot of these issues. Not only will their own systems operate in near real time, but they can also offer alternative means of remittance information capture and character translation.

Any attempt to maximize cash flow through streamlining bank account structures also needs to take into account local regulation when projecting implementation timelines.

Those corporations going overseas for the first time are often unaware of how long it can take to open a bank account in certain jurisdictions and the sheer diversity of account opening regulation across different markets. One way of minimizing this issue is to use a bank that has standardized global terms and conditions in all its account opening forms, but this still leaves jurisdiction-specific regulations, such as acceptable forms of signatory ID, with which to contend.

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Conclusion: finding the best fit

Even domestically, the effective management of cash flow and payment risk is considerably easier to achieve if the bank solutions used are tailored to individual corporate risk profiles, and are not merely ‘one size fits all’ products. Extrapolate this situation to new international markets and add in currency risk, and this bespoke methodology becomes effectively mandatory. The number of new variables involved that must be dealt with in this environment make a cookie cutter approach completely non-viable.

On the one hand, this clearly requires a bank with the ability to deliver this sort of flexible solution set at a conceptual level. But on the other, the effectiveness of any solutions this bank delivers will ultimately be hugely dependent upon its local expertise in the global markets a corporation wishes to enter. That not only requires an extensive physical presence and local knowledge, but also the ability to leverage and connect these resources at a global level for the ultimate benefit of the client.