UNIT 15 INTERNATIONAL CASH MANAGEMENT

Structure

15.0 OBJECTIVES

After studying this unit you should be able to :

- define international cash management
- explain the need for international cash management
- explain the techniques of international cash management
- distinguish between centralised and decentralised cash management strategies
- explain the role of transfer pricing in cash management.

15.1 INTRODUCTION

Management of short-term assets and liabilities - cash, investments, inventories, receivables and payables, is an important part of finance manager's job. When it comes to management of inventories, receivables etc. there is not much difference between a multinational and domestic firms. Among these cash management can be considerably more complex for multinational firms because of possibility of raising and deploying cash in many currencies, many locations and profit opportunities presented by imperfection in international money and foreign exchange markets. In this unit, you will learn about need and important techniques of international cash management, difference between centralised and decentralised cash management strategies, role of transfer pricing and movement of blocked funds.

15.2 NEED AND IMPORTANCE OF INTERNATIONAL CASH MANAGEMENT

15.2.1 Cash Management : A Global Perspective

The first question that comes to mind is: Why has it become important for firms to engage in international cash management? Well, the reason is not different from why firms are dealing in international marketing management or international financial management. Cash management like any other function can be examined from two perspectives: an intracountry perspective and an intercountry perspective. Intracountry cash management deals with the payment systems, banks, investments and borrowing sources available in a particular country. Intercountry cash management deals with cash movement among several countries. The key conceptual difference between intracountry cash management and intercountry cash management is foreign exchange. As corporations continue to expand their operations beyond their resident borders and money and foreign exchange markets remain volatile, managing cash resources globally increases in importance. You can well imagine the costs and the risks such firms face if international operations are not taken into account for working capital management. So, what according to you should be the objective of effective working capital management? Yes, you have guessed right – maximise net returns to the firm of all its borrowing and investment decisions.

The high costs of unutilised cash and high risks associated with unmanaged foreign exhange positions have virtually assured attractive rates of return on cash management improvements. High rates of inflation and the resulting high and volatile interest rates have increased the importance of cash management to the corporate treasurer. Concurrently, the expansion of many businesses into world-wide markets has created a need for international cash management. The objective of international cash management is to maximise funds availability at a set level of operating cost and foreign exchange risk, and hence excess cash can be effectively utilised.

The objectives, thus, of effective working capital management (of which cash management is an important component) in an international environment are: 1) to allocate short-term investments and cash balance holdings between currencies and countries to maximise overall corporate returns; and 2) to borrow in different money markets to achieve the minimum cost. These objectives are to be pursued under the conditions of maintaining required liquidity and minimising any risks that may be incurred.

15.2.2 Integrating Cash and Foreign Exchange Management

Management of cross border or inter-country cash flows involves integrating cash and foreign exchange management. In most cases, cash initially will be mobilised by currency and country. In managing the resulting cash position, whether positive or negative, the cash manager can pursue two basic courses of action. First, excess cash can be invested or deficit cash borrowed in the local currency. These actions do not affect a foreign exchange position. Second, the cash position can be adjusted by buying or selling the cash spot on the foreign exchange markets. This action transfers the foreign exchange position. On the other side, a foreign exchange manager can adjust a foreign exchange position by buying or selling currency spot, thus changing the cash position or by using forward contracts. Until the forward contract matures, the cash position would not be affected.

The problem of having numerous currency and country choices for investing and borrowing, which is the extra dimension of international finance, is shared by firms with local markets and firms with international markets for their products. There are additional problems faced by firms that have a multinational orientation of production and sales. These include the questions of local versus head office management of working capital and how to minimise foreign exchange transaction costs, political risks and taxes. Thus, foreign exchange management must be added to the traditional components of float management and bank account control in developing a conceptual framework for international cash management.

As with every other corporate activity, cash management begins with planning. The corporate long-term strategic plan and the annual business plan result in the preparation of budgets for each department. One of these, the capital budget, covering the planned capital expenditures for various time horizons, will generally not have an immediate impact on thecash manager. Rather, it underlies the company's long-term financial requirements. But the annual sales forecasts and the operating budgets, broken down by month or by quarter, do provide the basis for the statement of anticipated sources and applications of funds to be reduced by the treasury department to the cash budget. Thus, since the entire business of the company ultimately finds expression in cash movements, there is no way a treasurer can do any thorough cash forecasting without corporate plans and budgets as a foundation. While the operating divisions thus provide the basis for the treasurer's cashforecasts, he or she can, in turn, with knowledge of the financial system in various countries, provide valuable inputs to the divisions. With the treasurer's assistance, foreign exchange exposure on international transactions can be better controlled, special arrangements can be made for collections on large sales, or an unusual financing can facilitate the receipt of a specific contract. Such items will have their influence on the resulting payments. The treasurer can help to avoid problems with local banking practices and regulatory requirements with which an operating division is not necessarily familiar.

Sometimes, the incentive to venture into foreign currency denominated borrowing is reduced by the consideration of foreign exchange transaction costs, just as is the incentive to invest in foreign currency. Unlike the situation with investment, foreign currency borrowing may be discouraged by borrowing-lending spreads. This is because when foreign funds are raised abroad, lenders may charge foreign borrowers more than they charge domestic borrowers because they consider loans to foreigners to be riskier. However, if foreign funds can be borrowed in the domestic market, the investment-borrowing spreads need not change.

The objectives of a system integrating cash and foreign exchange management are to:

a maximise total cash or to minimise total borrowings in all currencies together, avoiding concurrent investment and borrowing unless there are arbitrage opportunities;

b minimise foreign exchange exposure levels and insure exposure netting;

c minimise fluctuations of foreign exchange exposure levels; and

d minimise transaction costs.

In meeting the objectives of an integrated system, it is important to understand how cross-border flows are generated in the normal course of business.

Along with a global perspective of cash management comes an expanded concept of the cash manager. The cash manager must have a strong knowledge of the basic business transactions of the corporation. The cash manager must keep abreast of emerging technologies, payment systems and banking practices in each country. Finally, the cash manager's role requires an understanding of foreign exchange and financing and an ability to integrate day-to-day decisions into the company's overall asset and liability management strategies.

Factos Affecting Working Capital/Cash Management

	Factor	**Implication**
1	Absence of Forward Markets	Keep funds in the currecny received if anticipated future need exists
2	Transaction Costs	Keep funds in the currency received; move funds to the domestic market
3	Political Risk	Move funds to the domestic market
4	Liquidity requirements	Keep funds in the currency most likely to be needed in the future
5	Taxes	Avoid high witholding taxes and keep funds in appreciating currencies

Unbundling Funds Transfer

The funds are transferred from the subsidiary company to the parent company. It is in the form of separate flows representing payments for various assistance provided to the subsidiary by the parent. An item by item matching is adopted for remittances representing payments for inputs from parent to subsidiary. This process is called unbundling of fund transfer. The important items through which unbundling is done are (a) dividend remittances (b) royalties, fees and overhead expenses. Dividend decisions are influenced by host country's tax laws, political risk, foreign exchange tax, age and size of subsidiary and existence of joint venture partners. Royaties and fees have tax advantage over the dividends if the income tax rate is more in host than home country. Royalties, fees and other payments are unusually not deductible locally. Thus unbundling helps in tax reduction. It also helps allocation of overheads and the entry of local capital into Joint venture projects.

15.3 CHANGES IN INTERNATIONAL BANKING

You surely agree that international banking and international cash management go hand in hand. The internationalisation on the corporate side has been paralleled by a similar development on the banking side. Banks have expanded beyond their resident borders through international mergers and the expansion of major banks. Banks are also focussing more on their international payment systems and cash management services. More and more attention is being paid to bank account control. So, what is bank account control?

The components of bank account control are 1) bank account architecture; 2) balance information; and 3) bank costs. Bank accounts should be structured to avoid idle balances. This is accomplished by establishing three types of accounts: collection accounts, a concentration account and disbursement accounts. Collection accounts channel funds into a concentration account; investments or borrowings occur from the concentration account; disbursement accounts are funded from the concentration account.

The method by which the proper bank account architecture is implemented varies widely by country. In certain countries, accounts are maintained with different banks, due to prohibitions against interstate banking. Movement of funds from collection accounts to the concentration account can occur by wire transfer or depository transfer cheque. A daily wire transfer arrangement can be used to transfer collected balances in excess of compensating balances to one or several concentration banks. The managers of the collection centres initiate the transfer on the basis of a daily report of estimated collected balances from their local banks. A depository transfer cheque arrangement is one whereby a depository cheque is drawn on the local bank, payable to a concentration bank. Funds are not immediately available at the concentration bank, for the cheque must be collected through the usual channels. The Fed-Wire system in USA is operated by the Federal Reserve and is used for domestic money transfers. Fed-Wire allows almost instant movement of balances, as well as the transfer of government securities, between institutions that have accounts at the Federal Reserve Bank. A transfer takes place when an order to pay is transmitted from an originating office to a Federal Reserve Bank. The account of the paying bank is charged and the receiving bank's account is credited. Whereas a transfer cheque may cost only about $0.10 to process, it is not as fast as wire transfer which may cost about $1.50. The delay must be analysed in relation to the difference in cost. For small transfers, a wire transfer is too costly compared to a depository cheque and should not be used. The earnings possible on investing the released funds may not cover the differential in cost.

Rapid transfers can also be accomplished through a bank's correspondent network, although it becomes somewhat more difficult to arrange same-day value for funds. Chief financial officers are increasingly relying on computers and world-wide telecommunications network to help manage the company cash portfolio. Many multinational firms will not deal with a bank that does not have a leading edge electronic banking system. At the heart of today's high-tech corporate treasuries are the treasury workstation software packages that many big banks sell as supplements to their cash management systems. Linking the company with its bank and branch offices, the workstations let treasury personnel compute a company's world-wide cash position on a 'real time' basis, meaning that the second a transaction is made in, say, Rio de Janeiro, it is electronically recorded in Tokyo as well. The simultaneous record keeping lets companies keep their funds active at all times. Treasury personnel can use their workstations to initiate fund transfers from units with surplus cash to those units that require funds, thereby reducing the level of bank borrowings.

Another means of accelerating the flow of funds is a lock-box arrangement. With concentration banking, remittances are received by a collection centre and deposited in the bank after processing. The purpose of a lock-box arrangement is to eliminate the time between the receipt of remittances by the company and their deposit in the bank. A lock-box arrangement usually is on a regional basis, with the company choosing regional banks according to its billing patterns. Before determining the regions to be used, a feasibility study is made of the availability of cheques that would be deposited under alternative plans. The company rents a local post office box and authorises its bank in each of those cities to pick up remittances in the box. Customers are billed with instructions to mail their remittance to the lock box. The bank picks up the mail several times a day and deposits the cheques in the company's account. The cheques are microfilmed for record purpose and cleared for collection. The company receives a deposit slip and a list of payments, together with any material in the envelop. This procedure frees the company from handling and depositing the cheques. The main advantage of a lock box system is that cheques are deposited at banks sooner and become collected balances sooner than if processing was done by the company prior to deposit. But, of course, that has to be balanced against the cost involved. Multinational banks now provide firms with rapid transfers of their funds among branches in different countries.

In many other countries, national banking allows accounts to be with the same bank. Money movement then involves internal accounting. Very sophisticated bank networks, such as those in Canada and Sweden allow cash to be pooled into one concentration account while maintaining sub accounts at the local operating level. This provides for a centralised pool of cash and decentralised book keeping and reconciliation.

Establishing a simple bank account architecture is not always entirely feasible. Foreign exchange regulations might force a separation of funds or tax regulations might limit the potential to move funds among subsidiaries. Less sophisticated banks do not always have the operational systems to pool or net accounts.

Given the best possible bank account architecture, balance information must be available to control balance levels in the concentration account and to adequately monitor collection and disbursement accounts. In many countries, the only ways to obtain balance information are through a daily statement, phoning the bank directly or requesting a telex. Sometimes, even if a bank is willing to provide timely balance information, it might not have the operating capability. Accounts are often maintained with a bank branch close to where a business is located, rather than the bank's head office. The branch might not have access to Society for Worldwide Interbank Financial Telecommunication (SWIFT), computer terminals or telex. Communicating through the bank's headquarters is time consuming and information needed to actively control balances becomes outdated. The SWIFT network connects over 900 banks on North America, Western Europe and the Far East. Its mission is to quickly transmit standard forms to allow its member banks to automatically process data by computer. All types of customer and bank transfers are transmitted as well as foreign exchange deals, bank account statements and administrative messages. To use SWIFT, the corporate client must deal with domestic banks that are subscribers and with foreign banks that are highly automated. To cope with some of the transmittal delays associated with cheques or drafts, customers are instructed to remit to 'mobilisation' points that are centrally located in regions with large sales volumes. These funds are managed centrally or are transmitted to the selling subsidiary. For example, European customers may be told to make all payments to Switzerland, where the corporation maintains a staff specialising in cash and portfolio management and collections. Sometimes, customers are requested to pay directly into a designated account at a branch of the bank that is mobilising the MNC's funds internationally. This method is particularly useful when banks have large branch networks. Another computerized network CHIPS (Clearing House Interbank Payments System) has been developed by the New York Clearing House Association for transfer of international dollar payments, linking about 140 depository institutions that have offices or affiliates in New York city. CHIPS handles about 1,05,000 interbank transfers daily valued at $350 billion. The transfers represent about 90 percent of all interbank transfers relating to all international dollar payments.

The final variable in bank account control is the cost of operating the account network. Let us go through the procedures of expediting cash movement once again:

How Multinationals Expedite their Collection of Receivables

Procedures for Expediting

Receipts of Payments	Conversion of Payments into Cash
Cable Remittances	Cable Remittances
Mobilisation Centres	Establishing Accounts in Customer's Banks
Lock Boxes	Negotiations with Banks on Value-Dating
Electronic Fund Transfers	Electronic Fund Transfers

15.4 IMPORTANCE OF CASH CYCLE IN CASH MANAGEMENT

International cash management is most easily viewed within the context of the overall cash cycle. Any cash cycle depends on the cash programmes that are designed in a firm. Well-designed cash programmes as you have seen follow a few simple ground rules:

1 There is cash management centre that receives and distributes timely information relating to cash movements on a number of bank accounts strategically placed to serve the needs of the company's operating divisions.

2 Information is distributed on the basis of a need to know which is different from cash requirements.

3 Short payment channels involving a minimum number of banks allow for maximum control.

4 Modern communication systems are used.

5 Efficient banks with high standards of customer service are employed.

6 There is a minimal impact on the internal corporate organisation, decision making pattern and accounting system.

With these ground rules in mind, cash management is divided into four areas: collection, disbursement, inter-company payments and control.

The cash cycle begins on the collection side with a customer transaction. Here, the float management objective is to accelerate receipts. Once funds are deposited and available for use, the objective is to control balance levels, maximising cash available to reduce borrowings or increase investments. If the currency of collection is different from the currency of disbursement, a foreign exchange transaction is necessary. The objective in his part of the cash cycle is to identify and manage resulting foreign exchange :xposures. On the disbursement side, the objective is to control float. Let us discuss more about float management.

Float Management: Float is created in business transactions when funds are moved from one party to another. Float is simply the availability of funds to one of the parties. In a normal transaction, these parties can include the payee, payer, one or several commercial banks and a central bank. In analysing a business transaction, four types of float can be identified: settlement float, transit (or mail) float, processing float, and clearing (or value-dating) float. Settlement float is the time between when a payee is requested to remit funds and when remittance is initiated. The float is available to the payee at the expense of the payor. Transit (mail) float is the time the payment is in transit. Most often, this is mail time, but it can also be, for example, courier time. Processing float is the time a transaction is literally in process - for example, the time it takes for a seller to prepare and mail an invoice or deposit a cheque that is already received. Clearing (value-dating) float is the time between deposit in the bank and when funds are available for use.

Methods for reducing the settlement and transit float vary considerably among countries. The variations depend upon normal country or industry payment practices and banking systems and practices. Managing processing float also varies considerably among countries.

Check Your Progress A

1 . What is bank account control?

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2 What is lock box arrangement? what is its purpose?

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3 What is float? Name the parties involved in it.

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15.5 CENTRALISED VS. DECENTRALISED CASH MANAGEMENT

Cash may be managed at one central location or at different locations i.e.it may be centralised or decentralised.

Sometimes, it is felt that it is necessary for each operating unit to deal with one central point rather than each other. The logic is that only a central unit can keep track of net amounts that a unit should pay or receive. In addition, a central unit can also do the following :

1 continuously monitor net open positions and take action;

2 identify all opportunities for netting exposures between operating units;

3 provide foreign exchange and investment expertise in support of the operating unit day-to-day activities and in maximising the foreign exchange profit potential inherent in their business (i.e., cross-border pricing decisions); and

4 provide centralised foreign exchange reporting.

Timing of settlements with the central unit is critical in controlling open foreign exchange positions. Currently, all units will settle foreign exchange positions at pre-specified time intervals. The disadvantage of this system is that, over time, foreign exchange positions can vary significantly. Often, these positions will be managed through short-term forward currency contracts timed to mature on settlement day. Funds are delivered and transactions are minimised. However, it can be difficult and expensive to match settlement dates and forwards exactly. Furthermore, many companies manage forwards at corporate headquarters, increasing coordination problems. An alternative method of controlling foreign exchange positions is to have settlements occur as a function of exposure level. Spot transactions are used to bring exposure within an acceptable range. The main advantage of this method is that foreign exchange fluctuations are kept within a set band. Undue risks are avoided. Fluctuations in the cash position within each country are minimised also, reducing borrowing needs or increasing funds available for investment. Recently, the concept of a centralised netting unit has been taken further. Some companies have established reinvoicing centers or captive finance companies providing for a total integration of cash management, foreign exchange management and liability management.

Advantages of centralised cash management

Netting : It is extremely common for multinational firms to have divisions in different countries, each having accounts receivable and accounts payable, as well as other sources of cash inflows and outflows, denominated in a number of currencies. If the divisions are left to manage their own cash, it can happen, for example, that one division is hedging a long pound position while at the same time another division is hedging a short pound position of the same maturity. This situation can be avoided by netting, which involves calculating the overall corporate position in each currency. The calculation requires some central coordination of cash management. The benefit that is enjoyed from the ability to net cash inflows and outflows through centralised cash management comes in the form of reduced transaction costs. The amount that is saved depends on the extent that different divisions deal in the same currencies and on the extent that different divisions have opposite positions in these currencies. The benefit also depends on the length of the period over which it is possible to engage in netting. This in turn depends on the ability to practice leading and lagging. Leading and lagging involve the movement of cash inflows and outflows forward and backward in time so as to permit netting and achieve other goals. When dealing at arms length, the opportunities for netting via leading and lagging are limited by the preferences of the other party. However, when transactions are between divisionsl of the same multinational, the scope for leading and lagging (for the purpose of netting and achieving other benefits such as deferring taxes) is considerable. Recognising this, numerous governments regulate the length of credit and acceleration of settlement by putting limits on leading and lagging. The regulations vary greatly from country to country and are subject to change, often with very little warning. If cash managers are to employ leading and lagging successfully, they must keep current with what is allowed.

Currency Diversification : When cash management is centralised, it is possible not only to net inflows and outflows in each separate currency, but also to consider whether the company's foreign exchange risk is sufficiently reduced via diversification that the company need not hedge all the individual positions. The diversification of exchange rate risk results from the fact that exchange rates do not all move in perfect harmony. Consequently, a portfolio of inflows and outflows in different currencies will have a smaller variance of value than the sum of variances of the values of the individual currencies. The determination of whether diversification will sufficiencly reduce risk can only be made properly when cash management is centralised.

Pooling occurs when cash is held as well as managed in a central location. The advantage of pooling is that cash needs can be met wherever they occur without having to keep precautionary balances in each country. Uncertainties and delays in moving funds to where they are needed require that some balances be maintained everywhere, but with pooling, a given probability of having sufficient cash to meet liquidity needs can be achieved with smaller cash holdings than if holdings are decentralised. The reason pooling works is that cash surpluses and deficiencies in different locations do not move in a perfectly parallel fashion. As a result, the variance of total cash flows is smaller than the sum of the variances of flows for individual countries. And then, if centralisation occurs in a major international financial centre such as London or New York, there are additional advantages in terms of a broader range of securities that are available and an ability to function in an efficient financial system. It is useful for a firm to denominate as many payments and receipts as its counterparties will allow in units of a major currency and to have bills payable in a financial centre. Contracts for payment due to the firm should stipulate not only the payment date and the currency in which the payment is to be made, but also the branch or office at which the payment is due. Penalties for late payment can help ensure that payments are made on time. The speed of collection of payments can be increased by using post-office box numbers wherever they are available. Similarly, if a firm banks with a large-scale multinational bank, it can usually arrange for head office accounts to be quickly credited, even if payment is made at a foreign branch of the bank.

Why decentralised cash management?

Unfortunately, it is rarely possible to hold all cash in a major international financial centre. This is because there may be unpredictable delays in moving funds from the financial centre to other countries. If an important payment is due, especially if it is to a foreign government for taxes or to a local supplier of a crucial input, excess cash balances should be held where they are needed, even if these mean opportunity costs in terms of higher interest earnings available elsewhere. When the cash needs in local currencies are known well ahead of time, arrangements can be made in advance for receiving the needed currency, but substantial allowances for potential delays should be made. In principle, it is possible to centralise the management of cash even if some funds do have to be held locally. However, complete centralisation of management is difficult because local representation is often necessary for dealing with local clients and banks. Even if a multinational bank is used for accepting receipts and making payments, problems can arise that can only be dealt with on the spot. Therefore, the question a firm must answer is the degree of centralization of cash that is appropriate and in particular which activities can be centralized and which should be decentralised. If interest parity always held exactly, the cash management problem would be simplified in that it would then not matter in which currency or country a firm borrowed or invested. However, there are factors such as transaction costs, political risk, liquidity preference and taxes which account for departures from interest parity at least from the perspective of any one borrower or lender. These factors affect the positioning of funds.

Transaction costs are a reason for keeping funds in the currency that is received if the funds might be needed later in the same currency. For example, if a firm receives 2 million won in payment for sales for its subsidiary in South Korea and needs approximately this quantity of won to meet a payment in a month or two, the funds should be left in Korean won if expected yields are not sufficiently higher in other currencies the two sets of transaction costs.

Political risk is a reason to keep funds in the company's home currency rather than in the country in whose currency the funds are denominated. This is because the home jurisdiction is generally the most friendly one. The reduction in political risk that results from moving funds home must, of course, be balanced against the extra costs this entails when the funds are converted into domestic currency and therefore must later be converted back into the foreign currency. Between most developed countries, the transaction costs of temporarily moving funds home are likely to exceed the benefit from reduced political risk, and so cash balances should be maintained in foreign countries. However, the political situation in some third world countries might be considered sufficiently volatile that only minimal working balances should be maintained in those countries.

Liquidity considerations argue in favour of keeping funds in the currency in which they are most likely to be needed in the future. This might not be the currency in which the funds arrive or the company's home currency. The liquidity factor is hence different from transaction costs, which suggest that funds should be kept in the currency in which they arrive, and it is also different from political risk, which suggest that funds should be kept at home. The words 'most likely' are used because it is the uncertainty of cash flows that is responsible for the need to maintain liquidity. If inflows and outflows were perfectly predictable, a firm could arrange the maturities for long-term securities so that each security would mature at the precise time the funds were needed. Complete certainty would do away with the so-called precautionary motive for holding money balances. However, even with uncertainty in the timing and amounts of cash inflows and outflows, extremely liquid money market investments and overdraft facilities at banks have allowed firms to keep most of their funds in interest-bearing instruments.

Withholding taxes are a reason to avoid countries whose withholding rates exceed the investor's domestic tax rate, because in such a case it will not in general be possible to receive full withholding tax credit. Lower taxes on foreign exchange gains than on interest income are a reason to invest in countries whose currencies are at a forward premium if the premium is treated as a capital gain. However, for firms that are heavily involves in dealing in many countries, foreign exchange gains and interest earnings are likely to face the same tax rates. There is, therefore, little need to favour any particular market.

15.6 ROLE OF TRANSFER PRICING IN CASH MANAGEMENT

Transfer pricing is a technique to transfer the funds from one location to another. The technique helps in positioning the funds at the desired location. Positioning of Funds means location of funds at various locations as decided by the marginal rate of return on investments. In case of MNCs there are constraints to the positioning of funds due to (a) disturbances in political environment. It may be explicit or implicit in the form of full or partial blockade of funds. Inconvertibility or exchange control are examples of explicit constraint. Heavy tax on income or dividend flows are example of implicit constraint. (b) tax policy in the form of multiplicity of tax structure (c) transaction costs in the form of ask and bid prices (d) liquidity considerations i.e. a particular level of liquidity necessary to maintain good relationship with banks and suppliers.

A transfer price can be defined as the price used for the internal sales of goods and services between the divisions of a business enterprise. The intra-firm sales which take place between the branches of an MNC create the need for internal prices to value the exchanges between the divisions.

Impact on Cash Management

Transfer price setting technique to position funds within a multinational enterprise to suit the management's working capital policies. A parent wishing to remove funds from a particular foreign country can charge higher prices on goods sold to its affiliate in that country. A foreign affiliate can be financed by the reverse technique, a lowering of transfer prices. Payment by the affiliate for imports from its parent, transfer funds out of the affiliate. A higher transfer (sales) price permits funds to be accumulated within the selling country. Transfer pricing may also be used to transfer funds between the sister affiliates. Multiple sourcing of component parts on a worl-dwide basis allows changes in suppliers from within the corporate family to function as a device to transfer funds.

15.7 MOVEMENT OF BLOCKED FUNDS

Situation of blocked funds arises when any government, due to foreign exchange crisis, limits the transfer of foreign exchange either partial or total. In such a situation MNCs have more at stake. In order to face such a situation, mostly international companies firstly incorporate the effect of blocked funds in capital budgeting. It is a pre-investment exercise done by such companies. Secondly, if the blockade is for a medium term the companies may resort to forced reinvestment in extending production facilities or in other real assets. Thirdly, a company may move out such funds by following methods (i) unbundling of cash flows (ii) transfer pricing (iii) leading and lagging payments (iv) fronting of loans (v) creating unrelated exports of host country (vi) obtaining special dispensation to repatriate. The first three methods have already been explained.

In fronting of loan or link financing the loan provided by parent to subsidiary is channeled through a bank or financial intermediary. The parent deposits the funds in a bank which then lends it to the subsidiary. The bank earns through this borrowing and leading process export of unrelated goods from host country helps both the foreign company and host country. It is risky to seek an escape route for blocked funds and it is better to seek permission from host country.

Check Your Progress B

1 What is netting?

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2 What is transfer pricing?

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3 Why is pooling done?

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4 State whether the following statements are True or False.

i) Fluctuation in currency affect the cash management of MNCs.

ii) Objective of international cash management is to allocate funds efficiently.

iii) The transfer of funds among subsidiaries and parent unit of a MNCs is done by royalties, fees and transfer pricing.

iv) Settlement float is the time the payment is in transit.

v) Transaction costs are the reasons not to keep funds in the currency that is received.

15.8 LET US SUM UP

Cash management can be examined from two perspectives: an intracountry perspective and an intercountry perspective. The key conceptual difference between intracountry cash management and intercountry cash management is foreign exchange. The high costs of unutilised cash and high risks associated with unmanaged foreign exchange positions have virtually assured attractive rates of return on cash management improvements. International cash management is most easily viewed within the context of the overall cash cycle. Cash needs can be met wherever they occur without having to keep precautionary balance in each country. Methods for reducing the settlement and transit float vary considerably among countries. The variations depend upon normal country or industry payment practices and banking systems and practices. Managing processing float also varies considerably among countries. The objectives of a system integrating cash and foreign exchange management are to maximise total cash or to minimise total borrowings in all currencies together, avoiding concurrent investment and borrowing unless there are arbitrage opportunities; minimise foreign exchange exposure levels and insure exposure netting; minimise fluctuations of foreign exchange exposure levels; and minimise transaction costs. The main advantages of centralised cash management are netting which involves calculating the overall corporate position in each currency rather than of each branch, currency diversification, i.e., a portfolio of inflows and outflows in different currencies will have a smaller variance of value than the sum of variances of the values of the individual currencies and pooling as cash needs can be met wherever they occur without having to keep precautionary balances in each country. Unfortunately, it is rarely possible to hold all cash in a major international financial centre. This is because there may be unpredictable delays in moving funds from the financial centre to other countries; i.e., there is political risk involved. Other reasons for decentralised cash holdings and positioning of funds are transaction costs, political risk, liquidity preference and taxes. Therefore, the question a firm must answer is the degree of centralisation of cash that is appropriate and in particular which activities can be centralised and which should be decentralised. Very often, firms use transfer pricing to suit management's working capital policies.

15.9 KEY WORDS

Float Management : Float is created in business transactions when funds are moved from one party to another. In analysing a business transaction, four types of float can be identified: settlement float, transit (or mail) float, processing float, and clearing (or value-dating) float.

SWIFT : SWIFT (Society for World-wide Interbank Financial Telecommunication) network connects over 900 banks on North America, Western Europe and the Far east. Its mission is to quickly transmit standard forms to allow its member banks to automatically process data by computer. All types of customer and bank transfers are transmitted as well as foreign exchange deals, bank account statements and administrative messages.

CHIPS : CHIPS (Clearing House Interbank Payments System) computerized network has been developed by the New York Clearing House Association for transfer of international dollar payments, linking about 140 depository institutions that have offices or affiliates in New York city.

Netting : Netting involves calculating the overall corporate position in each currency. The benefit that is enjoyed from the ability to net cash inflows and outflows through centralised cash management comes in the form of reduced transaction costs. The length of netting depends upon leading and lagging.

Pooling : Pooling occurs when cash is held as well as managed in a central location. The advantage of pooling is that cash needs can be met wherever they occur without having to keep precautionary balances in each country.

Currency Diversification : A portfolio of inflows and outflows in different currencies possible through centralised cash management will have a smaller variance of value than the sum of variances of the values of the individual currencies due to the fact that exchange rates do not all move in perfect harmony.

Transfer Pricing : A transfer price can be defined as the price used for the internal sales of goods and services between the divisions of a business enterprise. The intra-firm sales which take place between the branches of an MNC create the need for internal prices to value the exchanges between the divisions.

Unbundling of Funds Transfer : It is a process by which funds to parents from subsidiaries in the form of separate flows representing payments for various assistance provided by the parent.

15.10 ANSWERS TO CHECK YOUR PROGRESS

B 4   i) True   ii) True   iii) True   iv) False   v) False

15.11 TERMINAL QUESTIONS

1 What are the objectives of international cash management? Which of the gains from centralisation of cash management are related to foreign exchange transaction costs?

2 What are the advantages of centralised cash management? How can pooling provide benefits for international cash management? How does liquidity preference affect international cash management decisions?

3 What are the differences and similarities between the gain from centralisation of cash management via pooling and the gain via diversification of different currencies? Why do many governments restrict the maximum length of time over which firms can practice leading and lagging of accounts receivables and payables?

4 Why do transaction costs of spot and forward exchange reduce the incentive to borrow/invest in foreign currency securities? How can international transfer pricing be employed to manage a firm's working capital requirements?

5 What do you understand by positioning and unbundling of funds? What are the constraints on positioning funds? How blocked funds can be moved out of a country?