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Unwrapping Renminbi from 'Red Tape': A Perspective on China's Currency

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In recent months much has been written on the renminbi 's (RMB) increasing speed of internationalisation, following initiatives by the People's Bank of China (PBOC). From a liquidity management aspect this might seem very promising; embedding RMB in offshore cash pools sounds like a wish come true for many multinational corporations (MNCs). However as this article explains, treasurers who plan on making early use of these opportunities could find that China's foreign exchange (FX) controls are still in effect.

It is clear that China's new leadership, which took office in March this year, is more open to change than ever and the country's pace of financial market reform is expected to accelerate further. However, a certain form of control is still in place and will probably remain so for the near future.

There is a sharp contrast between the shift to full renminbi (RMB) convertibility and an upscale of portfolio flows between mainland China and overseas. The essence of full convertibility is renouncing control, thus allowing market forces to fully and freely respond to price signals in international markets. Scaling up portfolio flows can be done gradually though, in a very controlled way. Although many believe that liberalisation of the Chinese currency will continue, there are potential dangers in liberalising the yuan (CNY) too quickly ahead of domestic market reform, especially in the interest rate market.

RMB Participation in Offshore Cash Pools

A quick browse through the International Monetary Fund's (IMF) annual report on exchange arrangements and restrictions reveals that many countries have enforced measures of some sort to prevent free flow of currency across the border. So China is definitely not the only culprit. What does set the country apart is how the international financial community decided to refer to the Chinese currency, or more precisely how we differentiate between onshore renminbi (CNY) and offshore renminbi (CNH).

Offshore renminbi has already cleared the China border, hereby meeting the requirements set by foreign exchange (FX) controls. The main portion of these flows would be trade and approved capital flows. These CNH can indeed be part of an offshore cash management solution; not that recent an innovation - as a niche liquidity management bank, headquartered in the Netherlands, Bank Mendes Gans has been providing CNH in offshore notional cash pools since 2009.

Corporate treasurers and their colleagues seeking an opportunity to consolidate CNY with other currencies in an offshore multi-currency, multi-entity, notional liquidity management structure, will encounter a couple of other challenges. This is not only because of the same FX controls, but also due to the limitations of most cash management solutions in the market. Treasurers with multinational corporations (MNC) will find multi-entity liquidity structures effective, especially if they wish to avoid related party funding without giving up the benefit of reporting net on the balance sheet in order to keep interest bearing debt low. However, for a mainland Chinese subsidiary to participate, it would have to open an account offshore and also be allowed to transact a free flow of funds to this offshore account from an onshore account. Unfortunately the Chinese financial market reform has not yet reached this ultimate degree of RMB liberalisation, although this doesn't necessarily mean that all is lost.

The Two-step Best Practice Approach

The current regulation landscape in China allows utilising CNY for offshore purposes. With the approval of the State Administration of Foreign Exchange (SAFE) or the People's Bank of China (PBOC) it has been possible to connect domestic pools to offshore CNH liquidity management. The approval will stipulate a maximum sweep amount.

Background: Current best practice is based on so-called 'Cross Border Intercompany Renminbi Lending'. In July 2013 the PBOC issued the 'Notice on Simplifying the Procedures of Cross-border Renminbi Business and Improving Relevant Policies'. This clearly demonstrates how rapidly China's central bank can move forward, favouring companies that keep in touch with indigenous relationship banks. What started as a pilot in Shanghai in 2012 is now widely available in China: companies can request their mainland relationship bank to extend the loan to their overseas parent or affiliates, without regulatory approval - although there is a maximum limit applied. The loan amount cannot exceed the so-called loan quota, which - among other criteria - is based on total shareholder equity and RMB cash balance of total cash balance. Bear in mind that this loan quota might be removed in the foreseeable future, in designated cities such as Shanghai.

Step 1 - Lend offshore: The current pilot allows lending RMB directly to an overseas parent or affiliate. This is the first step of the two-step best practice. As treasurer of an onshore company you will find your efficiency greatly improved when it comes to dealing with your surplus cash. On the other hand offshore companies get funding at relatively low cost. From a liquidity management point of view this is still far from ideal. As the Chinese entity doesn't participate in the offshore notional pool directly, funds must actually move to an offshore entity. These RMB flows between the accounts of different legal entities create related party lending which, in turn, leads to an administrative burden if not tax challenges. For now this is unavoidable and has to be tolerated.

Step 2 - Pool notionally: Ideally, the offshore company does not have to convert RMB into another currency, as the repayment of the loan will also be in RMB. Any exchange would immediately result in a foreign exchange (FX) exposure that needs to be covered by some sort of hedge. To avoid this complexity and cost the RMB are, where possible, placed in a notional cash pool. The deposit serves as collateral for borrowing in other currencies. This is the second step of the two-step best practice. In true notional liquidity management structures, banks offer full offset between currencies without converting. However, it pays to look more closely.

Liquidity management structures are intended to help companies to bridge liquidity gaps. Some entities use their own excess cash (or local cheap funding) to fund other entities' operations that need cash. By freeing up internal working capital banks are circumvented. A proper liquidity management structure should facilitate subsidiary-based funding, whereby overdrafts at one end are funded by credit balances somewhere else. Key to this principle is the concept of one single interest rate per currency. Any other proposal - with a spread - would enable banks to earn a margin on money that wasn't theirs in the first place. Additionally, interest should be determined based on typical money-market rates.

What to avoid: As a number of the commonly-offered liquidity management structures are intended for cash concentration purposes only, it is advisable to look at the mechanics in detail. Cash concentration is often perceived as a technique to sweep credit funds into a single location, allowing the master to withdraw the excess. Efficient as this might seem, it carries an unexpected underlying limitation. It may very well be that the structure doesn't allow participating entities, except the master, to overdraw their account. In other words, only credit funds are allowed and overdrafts are not permitted. This side might seriously diminish the efficiencies you're looking for.

In those cases where overdrafts are permitted, don't forget to check how they are priced. Is the debit interest rate identical to the credit interest rate, or will a spread be applied? Furthermore, is the pricing based on a credit assessment of individual entities on a stand-alone basis, or on the head office?

Working with Multiple Relationship Banks

Delving a little deeper, what else might be of interest to the treasurer of an MNC during his/her liquidity management exercise? A bank-neutral solution perhaps? The vast majority of companies with global coverage would have already selected the best bank(s) in every region. Setting up a global liquidity management structure - in most solutions - involves having to move your accounts to the bank that is going to manage your liquidity. All the time and effort spent on account administration is money down the drain. Instead, you might opt for the simplest structure with the least number of accounts and layers, as they are usually only added to facilitate the bank's processes and not your own.

A bank-neutral solution, as offered by Bank Mendes Gans and some of its peers, allows global companies to consolidate their liquidity in an overlay structure that doesn't affect existing relationships with local banks. This is also of benefit to companies domiciled in China. Pursuing a global liquidity management solution without giving up local bank relationship is not impossible.

The Solution is Available

Admittedly, for those treasurers familiar only with doing business in fully deregulated currencies this doesn't sound like 'Columbus's egg' (a brilliant idea that becomes obvious with hindsight) just yet. But it is just a matter of time until the benefits can be distinguished from the 'red tape'. As far as RMB is concerned, the combination of notional pooling and cross-border intercompany RMB lending is the next best thing. It's out there and it's readily available; you just have to be firm in asking for it.

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