Navigate the Rise of the Global RMB

Insights from J.P. Morgan
<table>
<thead>
<tr>
<th>Topic</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreword</td>
<td>1</td>
</tr>
<tr>
<td>One Currency, Two Markets Part 1: Markets</td>
<td>2</td>
</tr>
<tr>
<td>Development of the CNH in the Secondary Market</td>
<td>8</td>
</tr>
<tr>
<td>Investment, Capital Raising and Funding</td>
<td></td>
</tr>
<tr>
<td>Opportunities in Offshore Renminbi</td>
<td>12</td>
</tr>
<tr>
<td>Theodorus S. Hadiwidjaja, CFA</td>
<td></td>
</tr>
<tr>
<td>Development of the CNH Bond Market</td>
<td>16</td>
</tr>
<tr>
<td>Murlidhar Maiya</td>
<td></td>
</tr>
<tr>
<td>Offshore RMB Loan Market</td>
<td>20</td>
</tr>
<tr>
<td>Melissa Tian</td>
<td></td>
</tr>
<tr>
<td>China Foreign Direct Investments – Advantages of RMB Intercompany Loan and Mitigating Risks</td>
<td>26</td>
</tr>
<tr>
<td>Rohit Srivastava</td>
<td></td>
</tr>
<tr>
<td>Secured RMB Financing through Hong Kong Monetary Authority Cross-Border Collateral Management Service</td>
<td>30</td>
</tr>
<tr>
<td>O’Delle Burke</td>
<td></td>
</tr>
<tr>
<td>Settlement</td>
<td></td>
</tr>
<tr>
<td>One Currency, Two Markets Part 2: Clearing and Settlement</td>
<td>34</td>
</tr>
<tr>
<td>Offshore RMB Clearing Markets: Liberalization or Fragmentation?</td>
<td>38</td>
</tr>
<tr>
<td>Masayuki Tagai</td>
<td></td>
</tr>
<tr>
<td>One Country, Two Currencies, Three Clearing Ways</td>
<td>42</td>
</tr>
<tr>
<td>Sean Brierly</td>
<td></td>
</tr>
<tr>
<td>International Trade in RMB – Aspiration or Adoption?</td>
<td>46</td>
</tr>
<tr>
<td>Jacques Ling</td>
<td></td>
</tr>
<tr>
<td>Payment Processing in RMB – Challenges and Opportunities</td>
<td>50</td>
</tr>
<tr>
<td>Jiwei Ye &amp; Tse Fungwong</td>
<td></td>
</tr>
</tbody>
</table>
Foreword

As China’s economy has grown rapidly, so too has demand for the Renminbi (RMB). Since the RMB internationalization initiative was first launched in June 2009, the RMB has matured and internationalized significantly from being a trade settlement currency, to an investment currency of choice. Simplification of trade requirements and opening up of the capital account via the RQFII scheme and RMB Foreign Direct Investment (FDI) has also further improved the development of the offshore RMB markets and broadened circulation of the currency. As a result, the offshore RMB (CNH) market has gone through tremendous changes, particularly in the development of the CNH foreign exchange markets, the bond markets and the establishment of the CNH Hong Kong Interbank Offer Rate (HIBOR) index.

In addition to the growth of the offshore capital and foreign exchange markets, several RMB clearing centers including Hong Kong, Singapore and Taiwan have evolved, along with the announcement from The People’s Bank of China (PBOC) of a RMB cross-border clearing system (CIPS). This has led to interesting dynamics when clearing and settling the RMB, versus other currencies.

Given the above developments and the increasing interest in the globalization of the RMB, we are pleased to present this Thought Leadership Booklet titled Navigate the Rise of the Global RMB: Insights from J.P. Morgan – a compelling collection of thought leadership articles providing insights from our senior business heads and subject matter experts within the Corporate and Investment Bank. Inside the pages of this booklet, you can look forward to gaining deeper understanding into the various topics covered under the two broad RMB themes of Investment, Capital Raising and Funding, as well as Settlement. These various articles, which are relevant to both financial institutions and corporations, include commentary on the emerging trends in the currency’s development. Just to highlight a few – we look into the opportunities and developments in the offshore RMB bond market, FDI in RMB, and how financial institutions looking to navigate the RMB environment can develop a clearing strategy.

Whilst the RMB market can be complex and significant restrictions still remain in place, financial institutions and corporations have a growing number of options for entering the market. The two sections on the One Currency, Two Markets, provide a concise guide to the products and services available in the market, and how investors can take advantage of these. China’s cross-border regulations, how the current systems operate, and the developments that can be expected in the coming years are also covered in some detail.

At J.P. Morgan, we stand in close partnership with our clients by capitalizing on these opportunities, leveraging on our established industry expertise, global capabilities and local knowledge, to provide best-in-class solutions and maximize the many opportunities ahead with the rise of the global RMB.

We trust you will find this book to be an interesting and insightful read.

Gregory Guyett
Chief Executive Officer, Greater China
J.P. Morgan
One Currency, Two Markets Part 1: Markets

Whilst the Renminbi (RMB) market can be complex and significant restrictions still remain in place, financial institutions and corporates have an increasing range of choices to enter the market. This section provides a concise guide to the products and services available in the market, and how investors can take advantage of the many opportunities available.

Onshore Financial Markets

The onshore RMB market remains highly regulated, with cross-border flows subject to stringent capital controls, and interest rates on deposits regulated by the People’s Bank of China (PBOC) within certain parameters. Non-resident institutions and individuals are not permitted to invest in RMB-denominated securities except through the Qualified Foreign Institutional Investor (QFII) and RMB Qualified Foreign Institutional Investor (RQFII) schemes, or the interbank bond quota. Mainland investors can use RMB to invest in overseas markets via Qualified Domestic Institutional Investor (QDII) products.

The Shanghai Inter-bank Offered Rate (SHIBOR) was launched in January 2007 as part of PBOC’s efforts to develop an official interbank interest rate benchmark for China’s money market. It provides a daily reference rate based on the interest rates at which banks offer to lend unsecured funds to other banks in the Shanghai interbank money market, where J.P. Morgan is also a participant.

Complex financial instruments such as derivatives or intricate financing structures have remained highly regulated for all market participants, and the regulatory authorities have been keen to maintain close control of market activities. The ability for corporations and banks to borrow overseas has also been limited by the authorities’ desire to manage the country’s foreign debt and prevent foreign currency speculation.

Chinese institutions intending to settle outward direct investment in RMB must obtain approval from the relevant authorities for both the transaction and offshore remittance of the funds, and they may then repatriate the proceeds of the outbound investment back into China. All transactions involving foreign exchange are strictly controlled by the State Administration of Foreign Exchange (SAFE).

Overseas Financial Institution Market Participation

Qualified Foreign Institutional Investor (QFII) Scheme

Since 2002, China has had a QFII scheme which divides applicants for QFII into various categories – fund managers, insurance companies, securities firms, banks, and other institutional investors such as pension funds, endowments, charity funds, and sovereign wealth investment companies.

Depending on their category, applicants must have a certain track record (for example, 2 years for fund managers and insurance companies; 5 years for securities companies; 10 years for banks), and a certain amount of securities assets under management (USD 0.5 billion for fund managers and insurance companies; USD 5 billion for securities companies and banks) outside of China. The QFII rules are designed to restrict access to approved foreign institutions, and each QFII is also limited by an investment quota. The permissible investment scope of QFIIs includes exchange traded stocks, bonds, warrants, fixed-income products in the inter-bank bond market, securities investment funds, and stock index futures.

Since late 2010, some foreign financial institutions (mainly central banks and overseas banks that facilitate the RMB cross-border settlement scheme), have been given quotas to trade in the domestic liquid interbank onshore RMB (CNY) bond market. In addition, since July 2012, the China Securities Regulatory Commission (CSRC) has allowed QFIIs in principle to participate in the interbank market (PBOC issued rules in March 2013), but case-by-case approval is required. The key difference between these banks and QFII-qualified investors is that these banks already hold RMB for trade settlement purposes (or through currency swaps in the case of the
banks, whereas the QFII-qualified investors hold U.S. dollars and therefore need to go through a currency conversion process first.

Under the current Chinese tax regulation, tax on interest income is generally exempted for government bonds, but other interest income, dividends and capital gains as derived by non-Chinese resident from China are not tax exempted. The actual tax policy on the above RMB investment for foreign investors has not been clarified by the Chinese tax authority, so investors should consult their tax professionals and legal counsel as appropriate to determine their specific tax position.

RMB Qualified Foreign Institutional Investor (RQFII) Scheme

RQFII is a policy initiative which allows qualified RQFII holders to channel offshore into investments in the mainland securities markets, and it may be considered as the RMB-settled version of the U.S. dollar-denominated QFII program. At the inception of the RQFII pilot in December 2011, only Hong Kong-based subsidiaries of Chinese domestic funds and securities firms were allowed to participate in the program. The scheme’s initial rules required a minimum 80 percent allocation to fixed income and capped the amount of equities held in a fund at 20 percent, which meant that RQFII products were primarily fixed income funds offered by subsidiaries of Chinese asset management firms.

Since July 2012, several Hong Kong-based RQFII managers have launched exchange traded funds under a widening of the scheme, tracking indices such as the CSI 100, CSI 300, FTSE China A50 and the MSCI China A index. At the request of authorities in Hong Kong, the quota for the RQFII program has been expanded to RMB 270 billion. In March 2013, the CRSC, China’s securities regulator, unveiled new regulations that expanded the program to include Hong Kong units of People’s Republic of China banks and insurers, as well as financial institutions domiciled in Hong Kong. The equity investment limit was also removed and RQFIIs will now be eligible to invest in equities, bonds, interbank products, funds, index futures, and convertible bonds. As of mid-2013, 30 financial institutions had been granted licenses, with a total investment quota of RMB 104.9 billion.

With the minimum 80 percent fixed income requirement removed and a broader range of institutions now able to launch RQFII funds, the product landscape should diversify over the coming years. Relative to offshore Chinese equities, the A-share market offers greater access to smaller banks and financials, the consumer, healthcare and industrials sectors, as well as a range of dual-listed stocks that trade at a discount onshore.

CNY Foreign Exchange

Designated Foreign Exchange (FX) Banks

The onshore Chinese interbank currency market operates on the National Foreign Exchange Trading Center (NFETC). The China Foreign Exchange Trade System (CFETS) electronically links its primary users, which are known as Designated Foreign Exchange Banks (DFEBs), and DFEBs can trade directly with other member banks in the CNY FX spot market, as opposed to trading only through CFETS. Foreign companies cannot buy foreign exchange directly from the interbank market, but must go through the DFEBs. Since March 2012, SAFE has allowed onshore banks to keep a small limit of overnight short USD/CNY exposures, the amount of which varies across banks.

Over-the-COUNTER (OTC) Trading

OTC trading and market-making mechanisms in the interbank FX market were first established in 2006, whilst also retaining automatic price-matching based transactions. The way that central parity of the RMB against the U.S. dollar is fixed was also changed, such that quotations of market makers are averaged to obtain the PBOC fixing, and the USD/CNY central rate is determined by market makers before the market opens each day. Since then, the original +/- 0.3% band within which CNY/USD inter-bank FX spot rates can fluctuate around the daily fixing, was widened to +/- 0.5% in 2007, and it was widened again in 2012 from -0.5% to -1%, thus creating more two-way volatility.

As of September 2012, spot USD/CNY and fixing rates have re-converged (Figure 1), triggering some profit-taking in long CNY Non-Deliverable Forward (NDF) outright and point positions. This convergence is primarily policy-driven, and the exchange rate regime may be evolving at a faster pace than expected by the market participants. If the PBOC’s FX policy aims to re-close the gap between the spot and fixing rates, the result will be an essentially stable RMB position, which would result in limited further upside in offshore RMB (CNH) points. If the spot rate is allowed to trade more freely within the +/- 1% band, the other hand, there is a possibility of a permanent functional separation between a market-driven spot rate and the daily fixings, and the NDF market would become a less reliable hedging tool unless it is migrated to a new reference fix that follows the actual spot more closely.

In the event of the FX regime evolving to more two-way variability rather than the current near-term appreciation bias, the short U.S. dollar hedge unwinding volumes are likely to increase.
The Evolution of the CNH Market

**RMB Center in Hong Kong**

Hong Kong was the first market to support a RMB clearing system outside of mainland China. It has the most developed CNH market today, with the widest range of RMB-denominated products and deepest liquidity pool, and it also boasts a multi-currency domestic clearing platform.

Taiwan, Singapore and London are also developing CNH centers and are discussed in further in the Clearing and Settlement section. We should also note that other countries have expressed their interests to become CNH centers, which will be an interesting development to watch.

Foreign central banks can hold RMB as part of their foreign exchange reserves or invest in RMB-denominated bonds in Hong Kong and mainland China. Banks can offer RMB products and services to local residents and non-Hong Kong residents, subject to restrictions. RMB conversions for residents are capped at RMB 20,000 daily and remittance to China on a same-name basis cannot exceed a daily limit of RMB 80,000. RMB personal loans and leveraged trading facilities for Hong Kong residents are prohibited, as are remittances by non-Hong Kong residents into mainland China, though non-Hong Kong residents have been allowed to purchase RMB since August 2012.

Foreign and Chinese companies, as well as mainland financial institutions, can issue RMB bonds and IPO in Hong Kong and remit the proceeds into China in certain situations. In addition to RMB trade financing facilities, RMB-denominated bilateral and syndicated loans, bankers’ guarantees are also available to institutional clients in accordance with Hong Kong banking rules and practices. In addition, RMB deposits, which are deposit-insured in Hong Kong up to a cap, may be used as collateral against loans.

Hong Kong subsidiaries of mainland securities firms, asset managers and other financial institutions which are domiciled in Hong Kong, can launch Securities and Futures Commission (SFC)-authorized RQFII funds in Hong Kong, as soon as these firms have obtained RMB QFII licenses from the CSRC and a quota from SAFE. RQFII holders are also permitted to issue RMB A-share exchange-traded funds to be listed on the Hong Kong Exchange (HKEx), that invest in composite equities of A-share indexes. The new crop of RQFII Exchange Traded Fund (ETF) products hold all the securities belonging to the underlying index (as opposed to previously available synthetic ETFs), and provide investors direct exposure to the A-share market at a lower total expense ratio, and at closer pricing to Net Asset Value (NAV). The world’s first deliverable CNH currency futures are now being traded, so that enterprises can hedge RMB currency risk.

Hong Kong’s Chinese Gold & Silver Exchange Society started trading gold quoted in RMB and the HKEx introduced a RMB Equity Trading Support Facility in October 2011.

The mainland China and Hong Kong Closer Economic Partnership Arrangement (CEPA) free trade agreement opened up new business opportunities for Hong Kong goods and services to the mainland, Hong Kong and all foreign investors. In particular, Hong Kong service suppliers enjoy preferential treatment in entering into the mainland market in various service areas, including financial services. In early 2013, a pilot program was launched to allow businesses in the Qianhai district of Shenzhen to borrow RMB from participating banks in Hong Kong, with the funds to be used...
to develop the area into a modern service industries hub. The development of the cross-border loan scheme in Qianhai, and potentially other pilot cities, constitutes another trial mechanism that allows the offshore currency to be recycled onshore.

**CNH Foreign Exchange**

Since 2010, the RMB fund flow in Hong Kong has been largely unrestricted, provided the funds do not flow back to the mainland. Existing channels for remitting CNH into China include foreign direct investment, cross-border RMB loans, proceeds of CNH bonds issued by Chinese institutions, investment via RQFII and RQFII-ETF funds, RMB investments by offshore central banks, RMB clearing banks, as well as offshore participating banks in China’s interbank bond market.

Accumulated RMB can be invested in a variety of investment products such as RMB deposits, bonds, Certificate of Deposits, REITS, Credit Linked Notes (CLN), ETF, structured products linked to underlying FX, gold, equity or interest rate instruments, RMB-denominated investment funds and RMB insurance policies.

Banks in Hong Kong can provide RMB currency products in the same way they provide products in any other foreign currency, such as USD or JPY, in line with normal banking laws. This practice has given rise to an offshore USD/CNH market in Hong Kong. All corporates and financial institutions, regardless of the nature of their business or investor profile, can access CNH products and hold CNH accounts, as long as they comply with normal banking laws in Hong Kong, without additional approvals from HKMA or SAFE. Alongside onshore USD/CNY and offshore NDFs, offshore USD/CNH now forms a third distinct market for RMB and offers a deliverable product that trades off the offshore CNH liquidity pool that has flowed into Hong Kong.

A two-tier exchange market for CNH exists in Hong Kong, with one market rate for RMB exchange for trade settlement purposes (subject to the quota of the clearing bank), and the other rate for general purposes quoted on the interbank market. With rising demand for RMB trade settlement and greater availability of the currency offshore, RMB foreign exchange derivatives such as RMB forwards, RMB options and RMB swaps have come into the market.

Daily volumes of offshore USD/CNY (HK) FX spot transactions now average USD 3 billion and transaction sizes average USD 10-20 million, with a bid-offer spread of about 5-10 basis points. Deliverable forwards are also available, with a daily volume of about USD 8 billion. While the market is quoted out to 1 year, liquidity tends to concentrate on the shorter durations.

Given the lack of free capital movement from the mainland to Hong Kong, arbitrage flows are still limited and there is a tendency for USD/CNH to trade below onshore USD/CNY. As shown in Figure 2, the CNY and CNH spot rates started to link quite closely after 2012.

An important reason is the connection between the liquidity pools of the two markets, as the Chinese government introduced new measures to boost the development of CNH market in 2012. Market participants can now move their funds between both markets via trade settlement and approved capital transactions such as FDI and shareholder’s loans. Therefore, any big gap can cause the arbitrage between these markets and finally smooth the divergence. Having said this, China still has capital controls, so a divergence between CNH and CNY spot rates is still possible. For example, the CNH spot was traded at a more expensive price against U.S. dollars at
the start of 2013, compared with the onshore CNY spot vs. U.S. dollars, due to a strong expectation of CNY appreciation, but the gap was quickly narrowed by following arbitrage flows.

Deliverable forwards are typically preferred for hedging purposes because they are generally eligible to be applied for hedge accounting, although organizations should seek their own accounting advice on this.

Corporations and financial institutions should be aware of the movements of these three markets (onshore, NDF and CNH) and use them to determine the best rate. Currently, many prefer Hong Kong as their offshore hedging center to other emerging centers (such as London and Singapore) because of the flexibility to hedge in different markets.

### Access to Liquidity

The biggest pool of liquidity today is from deposits. Hong Kong has the largest RMB liquidity pool amongst all offshore markets, with RMB deposits totaling RMB 698.5 billion (USD 110 billion equivalent as of May 2013), compared to a RMB 60.3 billion deposit base in Taiwan (as of May 15, 2013) and approximately RMB 60 billion deposited in Singapore (as of mid-2012).

Currently, liquidity in the CNH market is limited to client deposits, FX swaps, and the interbank cash market, with an intra-day repo facility from the designated clearing bank as the only available source of secured liquidity on an intraday basis.

In June 2012, the Hong Kong Monetary Authority (HKMA) introduced a RMB liquidity facility to Hong Kong banks to enable the use of the currency swap arrangement between the PBOC and the HKMA, to manage short term liquidity needs on the back of eligible collateral acceptable to the HKMA.

In May 2013, the HKMA revised this facility from a 2-day basis to a 1-day basis.

In addition, HKMA signed bilateral agreements with Clearstream, Euroclear Bank and J.P. Morgan to deliver a cross-border liquidity and secured lending channel in Hong Kong. The new service enables international financial institutions to use securities held with Euroclear Bank or J.P. Morgan as collateral in tri-party repo transactions with members of the HKMA’s Central Moneymarkets Unit (CMU), to access liquidity from Hong Kong, in particular HKD and CNH. Euroclear Bank or J.P. Morgan will act as tri-party collateral management agents for the repo transactions, ensuring that administrative obligations such as collateral valuations, eligibility, haircuts and substitutions are carried out automatically on behalf of the two counterparties to the securitized deal².

### Offshore Debt Market Offerings

The capital market is currently comprised of plain, fixed income instruments. CNH bond issuance grew from CNH 30 billion in May 2010 to CNH 503.5 billion in June 2013, with 188 issuers of 1,048 bonds, and the majority of outstanding bonds have a tenor of 3-5 years. Euro Commercial Paper (ECP) issuers have also started entering the market.

#### Dim Sum Bonds

The "dim sum" bond market generally refers to RMB-denominated bonds issued in Hong Kong and the majority of dim sum bonds are denominated in CNH, though some other bonds are linked to CNY and paid in U.S. dollars. China’s CNH-denominated benchmark sovereign bond curve is currently comprised of a single issue each of 3-year, 5-year, 10-year, and 15-year China Government Bonds (CGBs). These bonds were issued by the Ministry of Finance in the Hong Kong market in December 2010, August 2011 and June 2012. Their yields were initially significantly below mainland government yields, as they were commonly used as a CNY appreciation proxy, but as more repatriation channels are allowed and as depreciation expectation in CNY increase, the offshore CNH yields gradually converged with onshore. As of June 2013, the total outstanding was CNY 309 billion.

Bonds denominated in CNH can be settled using Euroclear and Clearstream, as well as in Hong Kong using the domestic settlement system HKMA CMU.

#### Certificate of Deposits (CDs)

CDs have become a core component of the dim sum product suite, and nearly 70 percent of all dim sum products in May 2013 were CDs, for example. It is also interesting to note that 82 percent of CDs are from financial services, 10 percent are from government, and the remaining are from corporates.

### Conclusion

Financial institutions and corporates have a multitude of channels and instruments available for investments that leverage the RMB in China, as well as in an increasing number of offshore locations. However, restrictions on investments are still in place and navigating the complex environment necessitates careful review of how best to leverage the various options available. Given the increasing range of investments and structures to leverage the RMB, gaining familiarity with the range of opportunities available can be beneficial to the investors, nevertheless.

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The offshore Renminbi (CNH) market has gone through tremendous changes over the past several years, starting with the development of foreign exchange (FX) in the CNH market, before moving to the bond market. While secondary market liquidity is currently low, the situation could well improve once planned changes and potential future developments materialize.

**Evolution of the CNH Secondary Market**

While trading in Renminbi (RMB) was largely done through the non-deliverable forward (NDF) market in the past and there was no spot market a few years ago, the CNH spot and forward markets have now taken over from the NDF market, and the CNH currency market is fully in place.

There are still opportunities for further development of the CNH bond market, however, particularly to improve the current lack of liquidity. The CNH bond market is primarily comprised of new government bonds with maturities ranging from two to ten years, auctioned by the Ministry of Finance once a year, and corporate bonds, which are usually issued by high-yielding corporations because highly-rated onshore issuers are not coming to the CNH market. Liquidity is low and is often linked to large moves in the FX market, both because investors buy and hold, and because investors do not want to sell when the RMB moves in their favour.

Several initiatives are already in the pipeline to improve the CNH bond liquidity. One initiative is the development of a repo market, which would allow market-makers to go long and short. The framework for the repo market is in place and documents are available for contracts between counterparties, and it will only be a matter of time before it expands. Another initiative was the launch of the CNH Hong Kong Interbank Offered Rate (HIBOR) on 24 June 2013, which supports the development of the interest rate swap market, provides an opportunity to hedge, and benefits the loan market development.

**Future Development**

Several additional developments would help expand the secondary market further. Investors normally buy and hold high-grade bonds which are difficult to find, and as high-yield bonds are also difficult to trade, an expanded issuance of CNH bonds driven particularly by middle-category and high-grade corporations, could increase trading significantly. More frequent issuances of bonds in varying maturities by the Chinese government would also be beneficial, because it would fill up the yield curve in a market where there are too few government bonds, and the supply is also limited by buy-and-hold investors. As such, these developments could lead to a more vibrant bond market with more active daily trading.

Another initiative that would expand the CNH bond market is greater participation by pension, bond and sovereign wealth funds. Today, investors often hold CNH bonds because they believe the currency will appreciate and corporations hold RMB for trade settlement. An increase in fund participation would expand the range of market participants, and it would fit with China's long-term objective of positioning the RMB to beyond just a transactional currency for trade, or a vehicle for investors to take advantage of currency movements.
An increase in fund participation would expand the range of market participants, and it would fit with China’s long-term objective of positioning the RMB to beyond just a transactional currency for trade, or a vehicle for investors to take advantage of currency movements.
Development of new offshore centers with more bond issuance, and with clearing banks bringing liquidity into markets like Singapore and Taiwan, will help increase liquidity and growth. The main avenue for offshore liquidity growth has been through trade settlement in RMB, which has been responsible for 80 to 90 percent of the liquidity in Hong Kong. Over time, there will not be a significant difference between Hong Kong and Singapore or other markets, so CNH markets will all become part of one even market and total liquidity will increase, with Hong Kong probably remaining the center because liquidity still tends to concentrate in one location.

On the regulatory front, expansion of the Renminbi Qualified Foreign Institutional Investor (RQFII) pilot scheme would help bring the onshore bond market closer to the offshore bond market. Traders will become more active and investors will become more comfortable with the CNH as markets converge more, and building a bridge between the onshore and offshore markets would be beneficial. Chinese authorities believe that opening markets too wide could lead to having too little control over capital coming onshore, which could affect the stability of the domestic market. Whilst increasing convergence will attract greater liquidity, the question now lies in the speed and extent of the market opening.

Managing Risk

Tactics to manage liquidity risk vary depending on the corporation, and although the CNH market is already similar to any mature market in some way, there is less liquidity and less choice of bonds. One important part of managing risk is having views on interest rate trends and the credit spreads for CNH bonds, which can lead to tactics for risk management. Investors can benefit from working with a trader or a portfolio manager who is focused on the CNH market and has a view on the market, so they can buy and manage risks appropriately.

Whilst becoming involved with the CNH bond market can be beneficial, investors should also be realistic, bearing in mind the restrictions on the market, and manage their involvement carefully because liquidity is lower.

The Role of Global Banks

As dismantling of capital controls continues, global banks have a role to play in building more bridges between the onshore and offshore markets, supporting government issuance of more CNH bonds, and supporting the ongoing expansion of the RQFII program. Global banks can also provide liquidity and develop products for clients to transact as the market evolves.

Conclusion

Whilst the CNH bond market has evolved rapidly and further changes are already on the way, additional steps will clearly improve secondary market liquidity. Investors can benefit from monitoring the market closely and working with partners to take full advantage of ongoing market liberalization.
Opportunities in Offshore Renminbi

By Theodorus S. Hadiwidjaja, CFA
Vice President and Credit Research Analyst, Columbus Fixed Income Team

As China’s economy has grown, so too has the demand for Renminbi (CNY or RMB). China’s onshore and offshore debt capital markets have grown tremendously. According to Asian Development Bank, China’s onshore bond market had grown to an equivalent of USD 3.8 trillion in outstanding bonds by the end of 2012.

Whilst the offshore CNY bond market in Hong Kong, also known as the CNH or the dim sum bond market, is smaller, it too has grown significantly and reached more than CNY 500 billion of outstanding bonds by the end of June 2013, according to HSBC. The desire to internationalize the RMB and the need for RMB to settle trades are both key factors behind the rapid growth of the CNH bond market.

The offshore CNY bond market is unique in that it is the only place where global investors can invest in RMB bonds issued by Chinese corporates and financial institutions, as well as by large foreign corporates such as Caterpillar or McDonalds. HSBC estimates that in 2012, 34 percent of new CNH bonds were issued by foreign corporates.

From an issuer’s point of view, in particular Chinese issuers, the CNH market is a viable option to raise capital at attractive rates, add investor diversification and raise its global profile. An increasing number of Chinese state-owned enterprises are issuing bonds in the CNH market to fund their overseas projects, while Chinese banks continue to be major issuers of CNH certificate of deposits to benefit from lower funding costs. On the other hand, foreign issuers tend to be more opportunistic, as they compare their funding costs in different currencies.

Whilst Chinese banks and trust companies are the dominant investors in the onshore bond market, the CNH bond market is driven by a more diverse group of investors that includes institutional fund managers, banks and private bank investors. Along with local investors in Hong Kong, investors from Europe and Singapore are amongst the most active in the market.

Differences with Other Markets

The CNH bond market is different from other bond markets in several aspects.

Firstly, the CNH bond market remains relatively short-duration, with more than 80 percent of bonds outstanding having tenors of three years or less, according to HSBC. Difficulties in forecasting RMB exchange rate movements mean that most investors prefer not to purchase bonds with a longer tenor. The recent launch of the CNH Hong Kong Interbank Offered Rate (HIBOR) Fixings provides investors a means to manage interest rate risks.

In addition, even though many bonds are issued by banks and corporates that are rated, a significant number of CNH bonds and certificate of deposits are not rated. A growing number of unrated issuers have also issued bonds in the CNH market.

Lastly, since the CNH bond market is still small, it is also relatively less liquid than other markets. Most investors buy and hold, which also makes the market less liquid.

The Attractiveness of the Market

Three factors make the CNH bond market attractive to investors.

First, despite the recent weakness, the RMB is still expected to maintain modest appreciation in 2013. While currency appreciation expectation has slowed down in recent months, higher rates offered on securities provide cushion, especially in the short-dated segment.
Investing in the CNH bond market, if done properly, can yield further returns whilst not necessarily causing investors to take on significant additional risks. Products such as funds that invest only in high-grade credits with relatively short duration targets, could be a suitable choice for investors who desire high quality investments that offer good diversification and liquidity, without being exposed to significant interest rate risks.
Second, investors can still benefit from higher yields compared to many other closely linked currencies. Whilst short-term high-grade bonds denominated in U.S. dollars, Hong Kong dollars or Singapore dollars typically yield less than 1 percent, CNH bonds of similar quality could now yield 2.50 percent or more. The yields in the CNH bond market are driven by yields in the onshore bond market, rate changes by the People’s Bank of China, the RMB appreciation expectation, and overall CNH funding conditions in Hong Kong.

Third, the CNH bond market offers investors access to Chinese companies and to the economic growth of China. The vast majority of CNH bonds are issued by Chinese corporates from a diverse range of industries, including banking, power utilities, transportation infrastructure, sovereign agencies and energy. The ‘Big Four’ banks, Chinese policy banks, and large state-owned enterprises continue to be major issuers. The ability of these large corporates to obtain regulatory approval to issue CNH bonds signals the Chinese government’s strong sponsorship of the CNH market and hence, lends further credibility to the CNH bond market.

**The Future of the CNH Bond Market**

Although China’s growth appears to be moderating and CNH bonds experienced a sell off in June, according to HSBC, CNH bonds still generated a 1.8 percent return (in U.S. dollar terms) in the first half of 2013. Recently, the onshore yields have become more of a driving factor on the offshore yields and as such, the rising yields presents more attractive investment opportunities in CNH bonds, especially in the investment grade, short dated segment of the market. As liquidity condition becomes tighter in the region, credit quality becomes an even more critical consideration.

In 2013, the growth of the CNH bond market is expected to remain healthy. Issuance in the first half of 2013 has been robust with a total of CNY 213 billion of bonds and certificate of deposits having been issued (up 24 percent year-on-year), according to HSBC. This is despite the decline in issuance of bonds in June 2013. Chinese banks should remain active issuers as banks continue to gather deposits. In addition, a growing range of corporates are likely to issue CNH bonds as they look to capitalize on the potentially lower offshore yields, if onshore funding conditions become tighter. Issuance by foreign corporates could also grow on the back of increasing trade settlement in RMB. Finally, Chinese and Hong Kong regulators are likely to remain supportive of CNH bond market growth and development, in line with the underlying themes of financial liberalization in China and RMB internationalization. The launch of CNH HIBOR fixings in Hong Kong in June 2013 will support the development of interest rate derivatives and CNH loans.

Investing in the CNH bond market, if done properly, can yield further returns whilst not necessarily causing investors to take on significant additional risks. Products such as funds that invest only in high-grade credits with relatively short duration targets, could be a suitable choice for investors who desire high quality investments that offer good diversification and liquidity, without being exposed to significant interest rate risks.

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**Theodorus S. Hadiwidjaja, CFA** is Vice President and credit research analyst within the Columbus Fixed Income team at J.P. Morgan. Based in Hong Kong, Theo has been with the firm for close to 13 years, and he is currently responsible for identifying investment opportunities in Investment Grade Asian credits for both the Global Liquidity and Columbus Fixed Income teams. Prior to joining J.P. Morgan, Theo was in trade settlement at Bank One Investment Management Corporation, and he was also a trading assistant at Banc One Investment Advisors Corporation.

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Development of the CNH Bond Market

By Murlidhar Maiya
Managing Director and Head of Debt Capital Markets,
Asia ex-Japan

While offshore Renminbi (CNH or "dim sum") bonds have been available in Hong Kong and other markets for several years, volumes were small until quite recently. The market is evolving rapidly and offers alternative features from other markets, and issuers and investors alike should consider whether now might be the time to issue or invest in CNH bonds and what developments are likely in the coming years.

The Evolution of the CNH (Dim Sum) Bond Market

Dim sum bonds are bonds issued offshore outside the People’s Republic of China (PRC) in CNH.

The CNH bond market started to grow rapidly after liberalization of trade settlement by the People’s Bank of China (PBOC) in July 2010 which triggered a rapid acceleration of deposits in Hong Kong in anticipation of Renminbi (RMB) appreciation and sparked interest by corporates in accessing this new pool of funds for financing. Despite the growth, the investor base has remained fairly narrow, constituting mostly of Hong Kong banks (or Hong Kong branches of Chinese banks) with surplus RMB deposits, insurance companies and private bank customers, who had more of a buy and hold strategy and rarely traded the bonds they invested in. This, coupled with the relatively modest size of most issuances, limited secondary liquidity.

By late 2011, as expectations of RMB appreciation tempered and spreads tightened to unrealistic levels relative to credit quality, transaction volumes fell. In 2012, only 23% of the total CNH issues were in the corporate sector compared to 46% in 2011. Financial institutions (mainly quasi-sovereign) dominated issuance volume in 2012 instead.

The market began to rebound in early 2013, supported by the further easing of cross-border capital controls, alignment of regulations governing CNH repatriation with repatriation of U.S. dollar bond proceeds, and a continuing increase in CNH deposits fueled by renewed sentiment on currency appreciation until the recent softening of RMB’s outlook. Further, a gradually deepening CNH swap market where investors can hedge currency risks has nurtured the growth of an institutional investor base. In a low-rate environment such as in the first half of 2013, global institutional investors looked to improve returns and increase diversification. The CNH market could offer them such an opportunity, and large global institutions (such as Halbis, Pinebridge, Invesco and JFAM) have set up dedicated CNH funds.

Considerations for Issuers

More corporate issuers are now looking to access the CNH bond market but they do need to consider the current structure of this market and some of its limitations.

The CNH bond market offers an attractive alternative financing pool for issuers that have heretofore accessed only U.S. dollar bonds. Most issuers in the CNH market have been well-known brand names (Chinese or MNC corporates) or well-established financial institutions. The focus on reputation rather than public ratings, coupled with a favorable cross-currency swap environment, has resulted in a benign issuance environment for high-yield issuers in this market in the first few months in 2013, where cost savings were available relative to the theoretical level of a direct U.S. dollar issuance. In fact, high-yield issuers represent approximately 35% of the issuing volume as of early May this year, compared to 7% and 19% respectively in full-year 2012 and 2011.
For the CNH bond market to grow further, a larger institutional investor base that can gradually create a more efficient secondary market is essential. A mature secondary market will enhance efficiency, enable firms to borrow under more transparent conditions and improve the sustainability of the market.
However, the dim sum market is still quite nascent in its development. The liquidity pool available is much smaller than the U.S. dollar market and as a result can be more volatile. For example, a typical CNH bond would range from RMB 1−2 billion in size, compared to typical high-yield U.S. dollar bond of USD 300−1,000 million. Most CNH bonds have no more than a 3-year tenor, though some 5-year and longer transactions have occurred. In contrast, the U.S. dollar bond market offers much longer tenors ranging from 3−30 years (depending on the specifics of the transaction). CNH market activities have dropped significantly since the turmoil in the broader bond market in late May, and may only pick up slowly relative to U.S. dollar markets given the shallow liquidity base and a weaker outlook for the Chinese currency. The cross-currency swap market is also relatively immature, with just a few transactions causing cross-currency swap basis to widen by tens of basis points, decreasing any savings compared to U.S. dollar issuances.

In considering the CNH bond market versus other financing options, issuers would therefore need to balance the shorter tenor and smaller quantum against the lower (swapped) funding costs that arise from time to time. Within these opportunistic windows, the CNH market environment can offer a relatively cheap source of funding, especially for non-investment grade issuers.

Considerations for Investors

While a wider variety of issuers and investors now participate in the CNH bond market, a key roadblock is continuing low secondary market liquidity. Initially, CNH bonds acted as one of the few investment opportunities for offshore commercial banks on their RMB deposits and were treated largely as buy and hold positions. However, as RMB appreciation reversed its track in early 2012, many investors were looking to sell the bonds but could not due to extremely poor secondary liquidity. Since then, the CNH deposit base has grown larger with CNH deposits now accumulating in other offshore jurisdictions such as Singapore and Taiwan. For the CNH bond market to grow further, a larger institutional investor base that can gradually create a more efficient secondary market is essential. A mature secondary market will enhance efficiency, enable firms to borrow under more transparent conditions and improve the sustainability of the market.

Furthermore, the USD/CNH swap market is still focused on short tenors – few investors have been willing to bet longer term on continued RMB appreciation. With improving secondary liquidity, a lower emphasis on currency appreciation as the sole motivation to buy CNH issues, and sustainability of the market as a liquid funding option for companies seeking RMB to invest onshore in the PRC, the swap market should start to allow for longer tenors of 5−7 years and beyond.

On hedging interest rate risks, the Hong Kong Treasury Markets Association at the end of May 2013, launched a CNH Hong Kong Interbank Offered Rate (HIBOR) fixing initiative to develop the CNH Interest Rate Swap (IRS) market. As such, investors will be able to invest on a relative value basis and focus on credit spreads. This move is expected to materially deepen the participation of institutional investors in the CNH market.

Regulatory Considerations

The PRC and Hong Kong governments have taken several incremental steps to streamline treatment of CNH proceeds in the last couple of years. To promote the dim sum bond market, the National Development and Reform Commission (NDRC) has also assigned quotas to leading state-owned enterprises (SOE) in China, allowing them to directly issue CNH bonds in Hong Kong. In addition, the Ministry of Finance has been a repeat issuer in the CNH market and is planning to issue RMB 23 billion this year, of which RMB 10 billion was auctioned on 26 June. Although control over cross-border capital flows still persists, and remittance of proceeds onshore is still subject to Foreign Direct Investment (FDI) quotas, we expect that CNH bonds, as an important component of RMB internationalization, will continue to grow over time.

The information herein constitutes our judgment at the time of composition, and is subject to change without notice.

Murlidhar Maiya is the Managing Director and Head of Debt Capital Markets for Asia ex-Japan at J.P. Morgan. Based in Hong Kong, Murli has held various key roles across investment banking over the 19 years he has been with the firm, including Mergers & Acquisitions and as a utilities and energy coverage banker. Prior to his current role, he was leading the Financial Institutions practice at J.P Morgan for Asia ex-Japan and China.
Offshore RMB Loan Market

By Melissa Tian
Managing Director and Head of Global Corporate Bank, Hong Kong

This article provides insights into how corporates can benefit from offshore financing in Renminbi (RMB), the market development of the RMB loan market, the impediments to growth, and recent developments of the offshore RMB (CNH) loan market.

Since the Cross-border Trade Settlement program was first launched in June 2009, the RMB has matured and internationalized significantly from being a trade settlement currency, to an investment currency of choice. Coupled with the RMB internationalization, relaxation of regulatory requirements and depreciative expectations on the CNH in 1H 2012 have helped the CNH loan market record successive years of growth from 2010 to 2012. By 2013, CNH denominated loans have become established as an alternative source of funding for Chinese corporates and other Multinational Corporations (MNCs) with operations in Mainland China. Demand from the aforementioned segments is expected to remain active and will play a fundamental role in driving the growth of the CNH markets.

Cross-border Trade Settlement

From its genesis in 2009, the scheme has gradually expanded to include more eligible Chinese companies and locations where trading partners are domiciled. All remaining restrictions on exporters were lifted in August of 2011, opening the floodgates for any Chinese exporter or importer to transact globally in RMB. Consequently, the market witnessed stronger and more widespread acceptance of RMB both as a trade and a payment currency in the following two years.

A pivotal location facilitating the rapid growth in RMB cross-border trade settlements is Hong Kong; where RMB trade settlements handled by banks in Hong Kong amounted to about USD 428 billion, around 90% of the total cross-border RMB trade settlement in 2012.
Whilst the CNH loan market already offers opportunities for corporates to lower their costs and increase efficiency, increasing liquidity and the development of reference rates as well as other ongoing enhancements, will make the market even more attractive for an increasing number of corporates to fund their growing business around the world.
CNH Deposit Market

Fueled by the vibrant cross-border trading activities and the ensuing trading surplus, excess CNH liquidity accumulated rapidly, leading to the birth of the CNH deposit market in Hong Kong (USD 52 billion in equivalent by Fiscal Year 2010). When the scheme was liberalized in 2011 to include all offshore trading partners, the CNH deposit pool in Hong Kong doubled to USD 108 billion; providing the critical mass and foundation to further develop the offshore RMB financing market and the CNH loan market.

CNH Loan Market

Market Development

In August 2011, the Ministry of Commerce (MOFCOM) in China approved Foreign Direct Investment (FDI) in RMB whereby foreign investors are allowed to remit RMB funds which are raised offshore to China via equity injections or shareholder’s loan to local entities. Whilst the market was once restricted to participants from the trade settlement scheme, MOFCOM’s liberalization threw the gates open to an influx of demand for CNH loans from companies looking to invest into China. Consequently, the amount of outstanding CNH loans grew exponentially from a paltry USD 0.3 billion (in equivalent) in 2010, to USD 5 billion by the end of 2011.

Although the CNH loan volume continued its upward climb during the first half of 2012, growth tapered off from the middle of 2012 till early 2013 due to a resurgent Yuan against the Greenback. Further brakes were applied on the red-hot market when the People’s Bank of China (PBOC) cut its indicative rates twice in June and July 2012, narrowing the funding gap (about 70–130 bps) between onshore and offshore loans and thus reducing demand for CNH. Although CNH loan volume went on to hit highs of USD 12.8 billion equivalent and USD 14.5 billion equivalent for the periods ending 2012 and 1Q 2013 respectively, the CNH loan market remains small as compared to the bond market, which achieved volumes of USD 38.5 billion and USD 42.4 billion during the same period.
Impediments to Growth in CNH Loan Market

Whilst loan demand is driven primarily by the borrowers who are incentivized by lower costs; the contrary is true for issuers in the bond market who are focused on RMB appreciation as the potential source of yields from their investments. Given the recent confluence of a resurgent Yuan against the Greenback and less competitive CNH lending rates, corporate treasurers will be hard-pressed to decide between offshore loans or bonds to fund their capital injections/loans.

Casting a shadow on CNH loans is the absence of an official benchmark CNH interbank rate in Hong Kong, leading to an opaque funding cost. Having a majority of CNH loans being bilateral in nature and syndicated or club deals making up less than 15% of the total loan volume, translates to a non-transparent market which encumbers potential loan market investors with greater degrees of uncertainty. Furthermore, CNH deposits are held almost exclusively by a small club of banks such as Bank of China, HSBC and Standard Chartered Bank, leading to minimal interbank liquidity as the banks have little incentive to lend CNH to other banks.

Why CNH Loans?

The key factor which draws Chinese corporates and MNC subsidiaries to CNH loans, is undeniably its relative lower cost as compared to onshore funding costs. In comparison to the CNH offshore rate, the onshore RMB benchmark lending rate (PBOC rate) has historically been higher. For example, a 1-year working capital facility which would have cost at least 4.2% from the onshore market (based on the previous lowest floating range of 70% applied on 1-year PBOC rate of 6%), could be obtained at a cost of about 3.9% from the offshore market (assuming 100bps spread on top of the base rate of 2.9% during Q1 2013), translating to a minimum savings of 30 bps. Further analysis into the funding rate gap between onshore and offshore for the period of January 2012 to May 2013 reveals an average difference of about 100bps, with the narrowest gap of 50 bps in August 2012 and the widest of 270bps in March 2012.

Besides lower costs, CNH loans are also favored by corporates for the comparatively simpler regulatory requirements to be complied with by the borrower, and a shorter speed-to-market cycle. Whilst a CNH-denominated capital injection will typically require just a MOFCOM approval, capital injections in other foreign currencies will require additional approvals from the State Administration of Foreign Exchange (SAFE), and a series of post-injection monitoring and reporting centered on the use of proceeds.
Recognizing the aforementioned obstacles in developing the offshore RMB financing market, the Hong Kong Monetary Authority (HKMA) has proposed the following measures to improve the liquidity of the CNH loan market:

- An official CNH reference rate determined by 13 major CNH participating banks launched in June 2013, set up the standardized interbank rate to boost the syndicated or club loan activities for greater transparency in the market.

- In view of the improving market liquidity of the offshore RMB foreign exchange and money markets, as well as the sound and sustained development of the RMB business in Hong Kong, HKMA removed RMB net open position1 and uplifted liquidity ratio restrictions2 in April 2013 to release more RMB into the inter-bank market to improve the CNH liquidity.

- Effective from July 20, 2013, PBOC has taken a major step forward in interest rate liberalization by removing lending rate controls. Key highlights of the de-regulation are as follows:
  
  - **Removal of lending rates floor** – Prior to the announcement, commercial banks could offer a maximum of 30% discount to the benchmark lending rates. This restriction is now removed and commercial banks can adopt differentiated pricing in lending rates.

  - **Removal of control on pricing mechanism of discounted bills** – In the new regime, discounted bills are priced at a premium above PBOC re-discount rates (which has stayed flat at 2.25% since March 2011).

  - **Removal of lending rate caps (2.3x PBOC benchmark lending rates)** on rural credit unions.

  - **No change to mortgage loans pricing scheme.**

Although the de-regulation is seen as a major step forward in interest rate liberalization, it has more symbolic meaning and limited impact on bank behavior as currently, no banks in practice offer discounts close to 30% from the benchmark lending rate as shown in the figure below.

![Figure 7: Distribution of Banks’ Lending Rates (1Q 2013)](Source: J.P. Morgan Research)

**Conclusion**

Whilst the CNH loan market already offers opportunities for corporates to lower their costs and increase efficiency, increasing liquidity and the development of reference rates as well as other ongoing enhancements, will make the market even more attractive for an increasing number of corporates to fund their growing business around the world.

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1 RMB net open position is the difference between on-balance sheet RMB assets and liabilities, but excluding any RMB structural position (e.g. investment in Mainland subsidiary banks).

2 As per the HKMA Circular dated 23 December 2010, all Authorized Institutions should restrict their RMB net open positions (whether net long or net short) to 10% of their RMB assets or liabilities, whichever is larger.

**Melissa Tian** is Managing Director and Head of Global Corporate Bank, Hong Kong at J.P Morgan. She is responsible for the local Hong Kong corporates, red chips and financial institutions, and has a regional responsibility for multinationals with regional treasury centers in Hong Kong. Melissa has a wealth of experience in delivering capital markets, risk management, hedging, treasury services and other corporate banking products to her clients, and was formerly a corporate banker with HSBC and Citigroup in New York covering the U.S. chemicals and industrial gases sectors. Prior to her current position, she was at HSBC’s Global Banking Management office in Hong Kong.
China Foreign Direct Investments (FDI) – Advantages of RMB Intercompany Loan and Mitigating Risks

By Rohit Srivastava
Executive Director, Global Emerging Markets

Funding needs of Multinational Corporation (MNCs) subsidiaries in China could be met partially through Renminbi (RMB) Intercompany Loan. However, it is imperative to understand the restrictions surrounding RMB Intercompany loans and how to mitigate the risks arising out of it.

As MNCs continue to expand in China, they often face complex questions on the optimal funding structure in an ever-changing regulatory environment. Even though local financing is available to most MNCs, the preference is always to tap more cost efficient markets for such financing needs and then fund their Chinese operations via Equity or Shareholder’s Debt (collectively, FDI into China). Historically, China allowed FDI to be denominated only in a few unrestricted currencies like USD, EUR, HKD and JPY. However, in October 2011, the People’s Bank of China (PBOC) allowed MNCs to structure FDI in RMB as part of RMB Internationalization, and this move significantly changed the way MNCs fund their local subsidiaries and manage the risk on such investments.

Between 2011 and 2012, the share of China’s inbound FDI conducted in RMB leaped from 12% to 35%1, as MNCs recognized the benefits of centralizing their treasury operations offshore and using China’s currency for these investments. These days, structuring FDI into China effectively and using tools to mitigate the resultant risks is crucial to a Corporate Treasury strategy.

Funding with a Shareholder’s Loan

After the October 2011 announcement on RMB FDI, a vast majority of MNCs are now using inter-company loans in RMB, also called RMB Shareholder Loans, to fund their Chinese subsidiaries’ growth. These loans offer significant advantages over other alternatives for funding.

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Firstly, such funding is much cheaper than the conventional RMB loans from a China-based bank, where the lending rates, till very recently, were regulated. Figure 1 compares the funding costs across tenors for U.S. parent {Aa1/AA+(M/S)} under the 3 stated options.

As the grid illustrates, there are significant cost savings under Option 1 vis-a-vis other alternatives and hence, most MNCs have preferred this route over any other option.

Secondly, it is easier from an administrative and operational standpoint for MNCs to lend to their Chinese subsidiaries in RMB than in USD (or any other currency). For a USD Shareholder loan, regulations still require local Chinese subsidiaries to obtain regulatory approvals for any conversion from USD into RMB. In the case of a RMB Shareholder’s loan, since the foreign exchange (FX) conversion is being done offshore using the CNH markets, no such approvals are required. However, Chinese subsidiaries are still required to obtain regulatory approvals for taking on Shareholder’s loans and such loans must still be routed through designated Foreign Debt Accounts.

Lastly, being able to fund a Chinese subsidiary in RMB has been extremely useful for MNCs that run and manage their FX exposure centrally at a Corporate Treasury level. The recent RMB liberalization measures (including RMB Shareholder’s loan) have allowed them to take the FX risks away from the local subsidiary, aggregate such risks at the Parent and then hedge the net exposures using CNH or CNY Non-Deliverable Forward (NDF) markets.

Whilst RMB intercompany loans offer many advantages to MNCs, regulations still limit the amount of such funding that MNCs can make available to their subsidiary, and size remains limited by the Borrowing Gap Quota as well as by Thin Capitalization rules.

Mitigating FX Risks under RMB Shareholder’s Loan using CNH Markets

With RMB internationalization, MNCs now have more options to hedge the risk on their investments in China. Even though MNCs have historically used NDF markets, they are now increasingly switching over to offshore-deliverable markets to mitigate their risks, as they find hedging in CNH more efficient and in certain cases, more economical. With the growing RMB liquidity pool in HK, the banks outside of China actively make market and quote prices in products like FX Spot, FX Forwards, Cross Currency Swaps. CNH Interest Rate Swaps (IRS) market activity is also picking up, following the launch of the CNH Hong Kong Interbank Offer Rate (HIBOR) in June 2013. All non-mainland Corporates, Institutions and Banks have access to the CNH markets and products, and there are no additional approvals required from China’s State Administration of Foreign Exchange (SAFE), the Hong Kong Monetary Authority (HKMA) or any other regulator to trade in these markets.

<table>
<thead>
<tr>
<th>Market</th>
<th>Daily Volume ($mm)</th>
<th>Transaction Size ($mm)</th>
<th>Bid-Offer Spread</th>
</tr>
</thead>
<tbody>
<tr>
<td>FX Spot</td>
<td>5,000</td>
<td>10-20</td>
<td>5 pips</td>
</tr>
<tr>
<td>FX Forward</td>
<td>20,000</td>
<td>20</td>
<td>10 pips</td>
</tr>
<tr>
<td>FX Options</td>
<td>2,000</td>
<td>50-100</td>
<td>0.1-0.5 vols</td>
</tr>
<tr>
<td>Cross Currency Swaps</td>
<td>150</td>
<td>10</td>
<td>3-5 bps</td>
</tr>
<tr>
<td>Interest Rate Swaps</td>
<td>25</td>
<td>10</td>
<td>40 bps</td>
</tr>
</tbody>
</table>

Source: J.P. Morgan Research

As companies grow more comfortable with RMB FDI, they are increasingly looking at how best to optimize the cost and efficiency of the process. A key factor in determining the preferred solution is the difference in the funding rates between the onshore and offshore markets.
The hedging strategy for RMB Shareholder loans varies widely across a range of companies. While companies are increasingly using long-dated Cross Currency Swaps (CCS) to hedge the risks, the most common practice is to hedge such exposures using a short-tenor rolling forwards (i.e., 1-month to 3-month tenor). In the current markets, the annualized cost of hedging using longer-dated CCS is cheaper than a rolling forwards strategy, so more activity is seen in CCS markets which have led to narrowing of bid-offer spreads, leading to lower transaction costs for the corporates.

Looking Ahead

An important recent development has been the launch of the CNH HIBOR Fixings by HKMA, and this new benchmark introduces an official money market benchmark for the CNH markets. Going forward, it is likely that many Banks & Corporates will start pricing various loan / credit products using this new benchmark and will likely lead to development of term money markets. The launch of the benchmark also facilitated the commencement of CNH IRS trading between banks and other institutions. The liquidity in this market is likely to improve significantly in coming months which will lead to tightening of bid-offer spreads.

As companies grow more comfortable with RMB FDI, they are increasingly looking at how best to optimize the cost and efficiency of the process. A key factor in determining the preferred solution is the difference in the funding rates between the onshore and offshore markets.

Structuring the Financing Effectively

Corporates can significantly increase the efficiency and ease of their operations by choosing the right alternatives for FDI into China, and by using the best tools for risk management. Corporates can therefore benefit from advice that helps them understand the market and regulatory developments, the implications of the various alternatives, and which solutions best fit their specific needs.

A bank with a global presence as well as a network in China can help with developing an optimal strategy for FDI based on the MNC’s structure. The global bank can also use its expertise in China and in other regions to build a regular dialogue with the regulators as well as investors. Amidst a complex and constantly changing market, corporates that leverage expert advice can optimize FDI structures and risk management for maximum advantage.

Rohit Srivastava is an Executive Director and Asian Markets Specialist in the Global Emerging Markets group at J.P. Morgan. Based in New York, he advises U.S. clients on a wide range of topics including RMB Internationalization, Foreign Direct Investment in Asia, Hedging Asian Market Risks and Capital Structures, with a focus on currency related issues in China and India. Rohit was previously responsible for growing the firm’s Corporate Derivatives footprint in North India, and he had established and led the Foreign Exchange desk in India. Before joining J.P. Morgan in 2007, Rohit was a FX & Rates Derivatives marketer at ABN AMRO Bank in India.
Access to liquidity is of paramount importance to the successful internationalization of the Renminbi (RMB), especially in the global financial market. For financial institutions that have RMB to lend, counterparty risk is a major concern. To mitigate this risk, these institutions sometimes conduct their lending through bilateral trades, such as swaps. However, to properly manage the operational risks involved in the trades, it is often at times best to use a collateral agent under a tri-party arrangement.

Whilst RMB liquidity can be sourced from financial arrangements such as loans or swaps, the repo market provides a standardized and secured means to facilitate access to liquidity in the Hong Kong market. In particular, tri-party repo financing provides important administrative and operational support for the valuation, control and safekeeping of collateral. Tri-party collateral management solutions that support repurchase agreements, or repos, are common in other markets but relatively new in Hong Kong. A repo arrangement offers an alternative and secure means to access offshore RMB liquidity (sometimes also referred to as CNH). Increasing liquidity through secured financing could also be a critical and indispensable component of the successful internationalization of the RMB.

In Hong Kong, like other Asian economies, the repo market has remained relatively underdeveloped compared to the more well-established markets in the United States and in Europe.

The Hong Kong Monetary Authority (HKMA) has been helping to increase access to secured financing by introducing new products such as cross-border collateral management service. This tri-party repo services platform was launched in 2012 to facilitate the development of the repo market. Since repos are a fully secured trade arrangement and provide recourse to the associated collateral if the counterparty defaults, they offer the benefit of mitigating counterparty risk more effectively. Thus, they should attract more investors and improve liquidity in the RMB market.

**Market Practices for Repos in Hong Kong**

Whilst tri-party collateral structures are common in the United States and in Europe, local banks in the Asia Pacific regions are less familiar with tri-party repo models and the operational framework supporting them. The HKMA has helped to establish and promote tri-party collateral...
The HKMA has helped to establish and promote tri-party collateral management in the domestic market by partnering with J.P. Morgan and other collateral agents. This provides an operational and service model that ensures that collateral supporting repo transactions are properly maintained; and collateral is valued appropriately on a continuous basis.
management in the domestic market by partnering with J.P. Morgan and other collateral agents. This provides an operational and service model that ensures that collateral supporting repo transactions are properly maintained; and collateral is valued appropriately on a continuous basis.

Similar to other markets where repos are already commonly used, the two principals in the transaction will sign the underlying global master repurchase agreement and set the commercial terms of the transaction for an agreed period. A local bank that is long on RMB cash and wants to use their funds for financing to earn more interest, for example, can lend to global banks or broker-dealers. Financing can be secured by deciding on the amount of collateral they will require to cover the amount of the repo for the duration of the contract, the type of collateral they will take, and how will they take possession of the collateral in the event of a default.

The collateral agent, which is the third party in the transaction, will ensure that operational practices for the program are managed effectively and in line with the terms agreed between the trading counterparties.

The Benefits of Repos for the Participants

The repo program in Hong Kong gives international market participants another option to source liquidity for trading activities in the RMB market, based on a familiar tri-party collateral management program. In fact, one of the key benefits of the program is that international banks or broker-dealers can leverage the securities collateral already lodged with their existing tri-party collateral agent to obtain RMB liquidity. It is expected that ongoing financial markets reform, especially in the context of the new capital regime introduced by Basel III, will provide further impetus to move from unsecured financing to using vehicles such as repos for secured financing of transactions.

Local banks lending RMB can also benefit from using the HKMA program, as they are able to access new trading counterparties and can also use a new vehicle that may enable them to receive a higher return.

Given these benefits, repos are important for the development of the capital market in Hong Kong and will help to develop a more liquid secondary market.

Growing the Repo Market

The HKMA has taken various steps to enhance the practicality of utilizing the repo program, such as extending the cutoff times for settlement to 11:30 p.m. Hong Kong time. The extended hours allow market participants located in Europe to participate in local Hong Kong trading, further expanding the pool of potential market participants the repo market.

Further effort is still needed to help local players become familiar with the operational and systems requirements to support repo transactions. By using experienced global collateral agents, the HKMA is helping to spread repo best practices from other markets to Hong Kong.

Increased familiarity with commercial terms common in the repo market by local market participants, is important for ensuring more successful trading relationships and market growth. For example, different levels of experience or risk appetite may cause a mismatch in terms of risk parameters, such as collateral haircuts that local institution prefers, as compared to what is typically amenable to a global institution. As such, using common best practices can help ensure that firms do not lose out on potential or existing trading opportunities.

Conclusion

Repos provide an alternative for global firms to access offshore RMB liquidity in Hong Kong, and for local banks to increase trading opportunities to lend their RMB deposits. The development of a local repo market is also an important aspect to support the internationalization of the offshore RMB market and further promote liquidity.

O’Delle Burke is an Executive Director for Agency Clearing, Collateral Management & Execution at J.P. Morgan. Based in Hong Kong, Burke is a senior product manager focusing on collateral management for derivatives, repos and securities lending. He is responsible for developing product solutions and executing on the business strategy. Burke has over 12 years experience in the Investor Services business, and he has held various roles covering markets in Europe, United States and Canada throughout the 17 years he has been with the firm. Prior to his current position, he was a Product Manager in the United States for J.P. Morgan Broker Dealer Services and Collateral Management.
One Currency, Two Markets Part 2: Clearing and Settlement

The Renminbi (RMB) clearing and settlement systems and practices are undergoing rapid changes, as China seeks to integrate its domestic clearing and settlement systems with international systems, develop new clearing centers and enhance the ease of payments. This section provides further insights into China’s cross-border regulations, how the current systems operate, and the developments that financial institutions can expect in the coming years.
Summary of China’s Key Cross-Border Regulations

| RMB Foreign Direct Investment (FDI) | • New rules on FDI using offshore RMB (CNH) announced as China started to close the loop of global circulation of the RMB (October 2011) |
| Expansion of RMB Trade Settlement to All Exporters | • The list of Merchandise Designated Enterprise (MDE) was removed (June 2012) |
| Clarification of Non-Resident Account (NRA) Rules in China | • Corporates are allowed to perform foreign exchange through a NRA, however, limited to the selling of Chinese Yuan (CNY) and buying of foreign currency and onward payment made in foreign currency. Limited scope of activities applies |
| Documentation Simplification – RMB | • The simplification of documentation practices vary across provinces in China • Nationwide policy issued in July 2013. Corporates not on the People’s Bank of China’s (PBOC) List of Enterprises Under Close Supervision may be able to further enhance their RMB payment efficiency with documentation requirement being reduced |
| RMB Cross-Border Lending | • Select companies received approvals from PBOC Shanghai on a case-by-case basis (pre-July 2013) • All companies in China are allowed to apply for RMB loans to overseas subsidiaries or affiliates (July 2013) |
| Regulations for Financial Institutions (FIs) | • FIs only allowed to book FX on the CNY spot rates to support merchandize trade within 3 months (June 2011) • FIs allowed to move funds between same name RMB nostros (with Offshore RMB Clearing Bank and its Onshore Agent Bank) in support of settlement |

The RMB Clearing Infrastructure in China

In mainland China, RMB is cleared domestically via the China National Advanced Payment System (CNAPS), which is a PBOC-operated RMB clearing system providing both real-time gross settlement and net settlement. The system has two modules: High Value Payment System (HVPS) and Bulk Electronic Payment System (BEPS).

HVPS is a real-time gross settlement for high value payments over RMB 50,000 and for urgent payments, as well as for all cross-border RMB flows regardless of the amount. Payments are processed continuously throughout the system’s operating hours, which run from 8:30 to 17:00 on China working days.

BEPS is a netting and batch clearing system for low-value (≤RMB 50,000) payments. The netting calculation runs 24 hours, 7 days a week, but settlement takes place 6 times a day at the national processing center, and 3 times a day at the city clearing processing centers from 10:00 to 16:00 on China working days.

To have direct access to CNAPS, a bank must have a settlement account at a branch of China’s central bank. All financial institutions in China that are approved to provide RMB services are eligible for direct access.

Figure 1: CNAPS Clearing Flow Chart

China National Advanced Payments (CNAPS) Clearing Flow Chart

Data Source: People’s Bank of China
Some of the distinguishing features of CNAPS, compared with other international systems such as the Clearing House Interbank Payment System (CHIPS) and Fedwire, include:

### International Payment Formatting Standards

CNAPS is not SWIFT-based and formats therefore differ from SWIFT guidelines. CNAPS Generation 2 has been rolled out across 2013/2014 and will be more in line with international standards.

### Charging Mechanism

CNAPS does not have an option to indicate BEN/SHA/OUR and all payments are treated on a BEN basis.

### Local Language

CNAPS has the capability to support beneficiary names and addresses in Chinese and Roman characters. SWIFT FIN is based on Roman characters, making it difficult to use SWIFT for all payment types. As Chinese companies become more international, use of Roman characters in beneficiary names is increasing, although there is still some way to go to achieve full efficiency.

### Offshore Clearing Infrastructures

#### Hong Kong

In 2007, the Clearing House Automated Transfer Service (CHATS), which is the Real-time Gross Settlement (RTGS) system in Hong Kong, was extended to RMB including:

- RMB interbank funds transfers
- Delivery versus Payment for RMB-denominated bonds through a linkage with the Central Moneymarkets Unit (CMU)
- Automated remittance of RMB funds relating to issuance of RMB bonds

Figure 2 depicts how banks settle transactions within the Hong Kong market and facilitate trade settlements into China.

#### Figure 2: Sample of a RMB RTGS Payment Flow

Note:
Merchandise Trade Transactions — Imports and exports payments/settlements with underlying goods transfers between parties
Service Trade Transactions — Payments and settlements for payments of fees, or services rendered by mainland firms

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1 www.hkici.com.hk
Differences between CHATS and other RTGS systems, such as CHIPS in the United States, include:

• **Intra-day Liquidity Management**
  Hong Kong member banks are required to observe throughput ratios to maintain efficiency, i.e., to release and settle no less than a certain percentage of the total day’s value of RMB payments by stipulated times at 13:30 and 16:30 Hong Kong time. Apart from critical payments, settlement may not occur on a real-time basis.

• **Use of a Commercial Bank as a CHATS Clearing Bank**
  Since the settlement institutions for CHATS are commercial banks, financial institutions participating in CHATS will have to manage commercial bank settlement risks.

• **Access to Liquidity**
  Settlement accounts are maintained with the appointed clearing bank and not with a central bank. Hence, access to liquidity from the central bank is not direct. Further details are provided above to show how liquidity is managed in the framework.

CHATS operates across extended hours (08:30 to 23:30 Hong Kong time) to support markets in Asia, Europe, the United States and Africa for RMB payments and settlements.

Fund transfers between different RMB accounts are allowed without restriction in Hong Kong.

**Singapore**

On 2 April 2013, PBOC and the Monetary Authority of Singapore (MAS) signed a Memorandum of Understanding (MOU) on RMB Business Cooperation, focused on reviewing the conduct of RMB businesses and clearing arrangements in Singapore, the RMB liquidity conditions and stability of the RMB market. PBOC and the Industrial and Commercial Bank of China (ICBC) Singapore branch also signed a RMB clearing agreement to formalize the clearing arrangements, allowing the ICBC Singapore branch to provide RMB clearing services to participating banks and their customers. RMB clearing in Singapore was launched at the end of May 2013. Since the launch, various financial institutions have issued dim sum bonds locally, and further developments including a RTGS clearing system are expected in 2014/2015.

**Taiwan**

In August 2012, China and Taiwan signed an MOU to develop a RMB and New Taiwan dollar (NTD) clearing system, and Taiwan’s currency authority also announced that the Bank of Taiwan’s Shanghai branch would be the clearing bank for NTD clearing in China. In December 2012, Bank of China’s branch in Taipei was later appointed as the clearing bank in Taiwan. This agreement allows qualified banks to be able to carry out cash exchanges of the currencies in accordance with relevant laws and regulations.

Since the start of RMB clearing operations on 6 February 2013, Taiwan has seen particularly rapid deposit growth. According to the Taiwan central bank, the RMB deposit balance in Taiwan had reached RMB 26.5 billion for Domestic Banking Units (DBUs) and RMB 30.4 billion for Offshore Banking Units (OBUs) by the end of April 2013. As of June 2013, 56 institutions had signed up as qualified banks.

**London**

The City of London Corporation has stated its interest in making the city an offshore RMB hub in the West, supported by banks and other private-sector organizations. This initiative has received encouragement and support from the governments of China and the United Kingdom. London is also continuing to review whether it should set up a RMB clearing system.

As a global financial center, London is already a trading center for RMB foreign exchange products, and handles an estimated 25 percent of the global offshore RMB spot market. Spot RMB trading volumes in London increased substantially to a daily value of $2.5 billion in 2012, a 240 percent increase from 2011. RMB-denominated bonds have also been issued in London.

To date, London has not announced the introduction of a clearing system.

**Conclusion**

Whilst the settlement and clearing system within China can be complex, it should become far easier to navigate as integration and compatibility with international systems increase, and as clearing systems in other markets proliferates, thus giving financial institutions and corporate more options. Tracking the ongoing developments carefully and ensuring that connectivity with existing and new systems operate smoothly — will be essential for ensuring that payments continue to be processed effectively.

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2 www.mas.gov.sg/Singapore-Financial-Centre/Overview/Regional-Gateway-for-RMB.aspx
The pace of the liberalization of the Renminbi (RMB) has been quite rapid, and so has the expansion in the number of clearing markets. Will the increase in offshore RMB clearing markets lead to fragmentation, or will it support the benefits of liberalization?

There is no doubt that the RMB is gradually becoming an international currency through various channels. Whether it will become an international reserve currency is a debatable topic amongst economists. In this article, we examine where and how the currency is cleared and settled outside of China, and the different drivers and historical developments of the U.S. dollar offshore clearing markets. By comparing U.S. dollar clearing markets outside of the U.S. with the current fragmentation in offshore RMB clearing markets, it provides a deeper insight into the future of RMB clearing and how financial institutions can better position themselves.

**Development of Clearing Markets**

As the Eurodollar deposit market started to develop in London in the 1970s, U.S. dollar lending and borrowing both in London and across Europe also began to grow. There were no major exchange controls on the U.S. dollar, and capital flowed relatively freely. However, settlement still took place in the U.S. using a cross-border payment system called Clearing House Interbank Payments System (CHIPS), and financial institutions carried out business in Europe while U.S. dollars were cleared and settled in the U.S.

Time zone differences allowed offshore markets to develop in parts of Asia to serve its domestic needs for U.S. dollars settlement. While it is unclear what will happen in the longer term, dollar clearing in Asia provides another rationale. Asian financial institutions were not comfortable that settlement took place in New York outside of their business hours, even though business was done in Asia. This resulted in the emergence of clearing markets in Asia.

In contrast with Eurodollar clearing occurring in the currency’s home market, the RMB has resulted in the development of several clearing markets outside of the home market. Even though Hong Kong has become the primary RMB clearing market, other markets like Malaysia, Singapore and Taiwan have had dialogues with The People’s Bank of China (PBOC: Central Bank) in developing their own RMB clearing markets.

One unique difference between Eurodollar and RMB clearing is the time zones. Most of the development of domestic RMB clearing markets is currently in Asia where markets are in similar time zones. The developments in Asia also do not mean every market needs to develop its own RMB clearing.

Whilst the United Kingdom (U.K.) has plans to become a RMB business center, for example, there is no indication that it will become a clearing market with its own RMB clearing and settlement system. Financial institutions in the U.K. generally assume that London will be the business center and RMB will be cleared outside the U.K., primarily in Hong Kong and China.

The rationale for development of a simple clearing model for the RMB may therefore be rather complex including features such as client demand and access to liquidity. Financial institutions are assessing whether the trend in the development of multiple RMB clearing markets continues and the implications, if RMB clearing becomes even more fragmented.
It is imperative to note that Central Banks with an offshore RMB clearing system will have to build a mechanism to enable participating banks to draw down on established liquidity lines, in the event of an emergency.
Drivers of Fragmented Clearing

A key driver of fragmentation is that the onshore RMB market in China is highly regulated and subject to capital controls. Only in recent years has China started developing offshore markets, first through allowing cross-border trade settlement and then by gradually expanding the usage of RMB in and out of China.

The offshore clearing market in Hong Kong was allowed to grow via relaxation of regulations in China. Regulatory changes allowed banks outside China to start accumulating deposits in RMB. Those deposits then became a source of liquidity. Corporates or individuals holding RMB deposits also started to look for ways to invest the RMB accumulated in Hong Kong, which stimulated the development of capital markets. These developments led to the need for a clearing market, since restrictions in China meant transactions could not be settled in China.

Until 2012, the assumption was that Hong Kong would be the single RMB offshore clearing market, similar to the U.S. for Eurodollar clearing. Now, however, developments similar to what happened in Hong Kong are beginning to take place in other countries such as Malaysia, Singapore and Taiwan.

PBOC has supported this development by appointing a designated RMB clearing bank in each market, where financial institutions open a RMB account with that bank. If the clearing bank does not have sufficient RMB liquidity, it can draw liquidity from its head office up to a pre-determined quota. PBOC is opening central bank swap lines in many jurisdictions that may be drawn upon if there is an emergency need for liquidity. It is imperative to note that Central Banks with an offshore RMB clearing system will have to build a mechanism to enable participating banks to draw down on this line, in the event of an emergency. This was developed with the Hong Kong Monetary Authority (HKMA)’s liquidity facility.

One other significant development alongside the RMB clearing banks is that China is developing its own payment system for cross-border RMB settlement, vaguely known as the China International Payment System (CIPS). Currently, tens of thousands of banks in China connect to the China National Advanced Payment System (CNAPS), while cross-border payments are carried out through traditional correspondent banking arrangements. In the U.S., thousands of domestic banks connect to FEDWIRE while 50 participants at CHIPS focus on international U.S. dollar payments. Whilst the interactions between CIPS and CNAPS are yet to be known, it may be reasonable to expect that China is looking for a similar set up with CNAPS, focusing on domestic traffic while CIPS contributes to the internationalization of the RMB.

Implications of Fragmented Clearing Markets

The development of many different RMB clearing markets could mean that the capacity of each market may be capped by the capacity of the clearing bank and its access to RMB liquidity in China. Financial institutions may need to source liquidity from elsewhere if there is insufficient liquidity locally, and move liquidity to the required market in a timely manner. As such, management of liquidity may become complex.

Financial institutions may require different arrangements depending on the originating point and ending point of a payment. Furthermore, most developments of domestic RMB clearing markets are currently in Asia, in similar time zones. Liquidity challenges could become a disincentive to developing clearing in other time zones. As a solution to cope with time zones and multiple clearing markets, some global banks may concentrate their offshore RMB activities in a single market, such as Hong Kong. It may make sense for the clients to open accounts in markets close to where liquidity is sourced, regardless of their location.

Conclusion

As the evolution of RMB clearing continues, global financial institutions will need to monitor developments and make decisions carefully so they can support their clients efficiently and cost-effectively. Financial institutions that use a correspondent banking relationship will therefore need to select their partner carefully, so that they can leverage the support which their corporate clients need.

Masayuki (Mike) Tagai is Managing Director and Global Market Infrastructures Executive for Asia Pacific at J.P. Morgan's Corporate and Investment Bank. Based in Tokyo, Mike is responsible for coordinating the firm's activity with international market infrastructures and industry associations in Asia Pacific, as well as monitoring regulatory trends and market practice issues that affect the financial market structure development. Prior to joining J.P. Morgan, Mike was previously with the Bank of Tokyo-Mitsubishi UFJ for 27 years. He has extensive experience in transaction banking and industry issues management, and has been involved directly in the Asia community advocacy of ISO20022 standards, Japanese payments market deregulation, and the Asia Bond Market Initiative of the ASEAN +3 countries. Mike also serves on the SWIFT Sanctions Advisory Group and the ISO20022 Registration Management Group.
One Country, Two Currencies, Three Clearing Ways

By Sean Brierly
Vice President, RMB Product and Clearing, Treasury Services

With change being a constant in the Renminbi (RMB) clearing market, financial institutions domiciled outside of Greater China will be challenged to determine the best approach for market entry. This article provides insights for financial institutions looking to navigate the RMB environment and developing a clearing strategy.

Market Background

Ever since RMB internationalization began in the early 2000s for individuals, and as it opened to corporates in 2009, there has been a continuing series of policy changes by the Hong Kong Monetary Authority (HKMA) and the People’s Bank of China (PBOC). While the frequent changes to business rules, message formats, liquidity rules and other practices designed to make the use of the RMB easier, constant change has also made it challenging for some financial institutions to finalize their strategy.

Over the past year, changes to practices have stabilized and the continued push by China to internationalize the RMB, coupled with increased confidence amongst the business community to utilize the RMB in settlement, has resulted in a significant increase in the number of financial institution entrants into the offshore market.

The recent announcement of a new China International Payment System (CIPS) brings about another change, however, and it is causing financial institutions looking at entering the market to consider which clearing system to connect to, the potential costs, future barriers to entry, and determine if there are any first mover advantages.

Two Currencies

One part of the consideration is whether to use the onshore RMB (CNY), which is useful for suppliers in China but also results in difficulties due to regulatory and documentation requirements; or whether to use the offshore RMB (CNH), which is more freely traded and more easily convertible. Whilst China has just one currency from an International Organization for Standardization (ISO) perspective, two foreign exchange markets have evolved — the CNY and the CNH. The CNY rate can only be accessed for merchandise trade within a three month period. Financial institutions are not able to access the CNY rate in the overseas markets and can only access this via the Mainland Chinese Correspondent Banks (MCBs), on the provision that they are able to abide by the PBOC regulations. In addition, overseas financial institutions will be required to open a nostro account with a MCB and liquidity will be limited to the individual MCB’s assigned quota. The CNH rate is more freely traded and more easily convertible.

Along with looking at regulatory or convertibility factors, financial institutions also need to evaluate the products that clients will need, how they service these clients, optimize interest rates, and whether they will need to move funds in and out of Hong Kong. For example, if a financial institution decides that it needs to expand its product offering significantly so that it can provide different products for different clients, it has to consider factors such as the clients’ target markets and how much CNY regulations may hinder the clients’ businesses.
Key determining factors when choosing a clearing system would be access to liquidity, counterparty and settlement risks, investment costs of integration and client needs.
Three (or More) Clearing Systems

As the number of overseas RMB Clearing systems increase, financial institutions will need to determine which RMB clearing systems to use and connect. Financial institutions have access to the Hong Kong’s Clearing House Automated Transfer System (RMB CHATS), or they can develop RMB clearing systems in other locations such as Singapore and Taiwan Overseas clearing systems which can be used for domestic settlement, direct links/settlement into mainland China or via correspondent banking. Alternatively, if the beneficiary is in mainland China, they can use a MCB for clearing via China National Advanced Payment System (CNAPS). Financial institutions can also wait for CIPS, which will become available by 2014/2015. CIPS and the MCB/CNAPS models can only be used to support settlement with mainland China.

Key determining factors when choosing a clearing system would be access to liquidity, counterparty and settlement risks, investment costs of integration and client needs.

The appropriate solution is specific to each financial institution. They need to consider infrastructure requirements including settlement requirements, transaction costs, reciprocity, regulatory reporting, client and market cutoff times, and the knowledge of their staff. Financial institutions should also conduct financial analysis of the fixed and variable cost of entry into the market.

For a branch-based financial institution whose home-country business clients have large suppliers in China, it may be preferable to establish a correspondent bank relationship. For another financial institution with a strategy to expand into Asia, on the other hand, setting up a local branch in Hong Kong and connecting into local infrastructure may be more effective.

Regardless of which options financial institutions select, they will need to consider whether to route payments from all their branches into one branch and then into the clearing system, or whether multiple branches will connect directly into the clearing system, as well as how to manage liquidity, nostro accounts, reconciliation and other internal processes.

Financial institutions can consider developing those connections themselves, and use a global bank with extensive experience in clearing as a single point of contact globally to transact in RMB, so that all the financial institutions branches can use the same channel to transact in RMB regardless of whether they are in London, Singapore, Taiwan or another market (pending local regulations).

Financial institutions may find that only large global banks can offer the broader experience, contacts and network that provide better support for the financial institution’s own clients, and the assurance that transactions have been completed. With their depth of experience globally in on-boarding clients and offering clearing services, global banks can also provide the international service levels and customized solutions that financial institution clients expect, as well as the thought leadership and knowledge of policy changes that enable the financial institution to better position itself.

Conclusion

Having one country with two currencies and three clearing ways can make it more challenging for financial institutions providing RMB clearing services for their clients. Analyzing the market carefully and leveraging experienced partners can help in determining the optimal and most efficient solution.

Sean Brierley is Vice President of RMB Product and Clearing for Treasury Services at J.P. Morgan. Based in Hong Kong, Sean has been with the firm for over 5 years, and was most recently the Head of Infrastructure for Treasury Services in Asia Pacific. He has over 10 years of experience in the banking and telecommunications industries across operations, management and technology consulting, and has previously worked in London and Europe.
International Trade in RMB
– Aspiration or Adoption?

By Jacques Ling
Executive Director and Senior Product Manager, Treasury Services

As usage of Renminbi (RMB) for trade settlement gains traction, there is considerable interest amongst corporates and financial institutions about whether and when they should establish RMB capability to ensure their full participation in this growing trend within the international trade arena.

Growth in Demand for International Trade in RMB

There has been continued strong growth in RMB trade settlement, with cross-border trade in RMB growing by 41 percent from RMB 2.09 trillion (USD 336 billion) in 2011, to RMB 2.94 trillion (USD 474 billion) in 2012. RMB cross-border trade now accounts for more than 16 percent of China’s total trade as of February 2013, according to CEIC Data.

When non-Chinese corporates consider using RMB, they are sometimes deterred by foreign exchange risks, convertibility issues and determining how they would deploy the RMB they receive. After further deliberation, however, many corporates have found that they simply cannot ignore the potential of the world’s second largest economy, the benefits of its currency, and that they may actually lose business if they cannot respond to the preference of Chinese corporates that are key dominant players in their supply chain to transact in RMB.

With more corporates now looking at the ability to conduct trade in RMB, financial institutions see the importance of having RMB capabilities to meet their clients’ needs and are thus developing capabilities to support clients directly, or through their correspondent bank. In Hong Kong, according to Hong Kong Interbank Clearing Limited (HKICL), the number of banks offering services in RMB has more than doubled from 65 in 2010, to 177 as of June 2013.

Benefits of Using RMB for Trade

Chinese corporates with operating costs in RMB gain clear advantages from using their home currency for trade, as settlement in RMB enables them to match revenue with expense, and reduces hedging costs.

Non-Chinese corporates have also found that conducting trade in RMB enables them to gain more business opportunities, improve pricing, and reduce currency conversion costs by keeping the funds they receive in RMB. For example, if a Singapore corporate and a Chinese corporate that are conducting business together agree to settle the trade in RMB, both can benefit from using RMB by sharing the savings where only one of the parties has to incur foreign exchange costs.

With the continued pace for RMB to achieve full convertibility, it will also benefit the international trade community with an alternative trade settlement currency to the current major currencies such as the U.S. dollars and Euro.
Financial institutions and corporates alike can benefit from working with a global bank that has a RMB strategy, investments to support the strategy, access to regulatory and market updates, new trade products to support their needs, and the innovation to keep them at the forefront of their industry.
Capabilities for RMB Trade

Corporates that prefer to use RMB for trade are looking into setting up accounting structures, systems, treasury policies and procedures to accommodate RMB, and they are incorporating foreign exchange, tax and legal issues into these reviews as well.

Along with developing internal capabilities for RMB trade, global banks have started to provide advice on foreign exchange management, hedging strategies and investment options for holding RMB balances. Global banks are also advising corporates on solutions such as setting up a trading house, re-invoicing or Treasury Centers to support these RMB transactions.

Support for Growth of RMB Trade

Along with demand from corporates, Chinese regulators are pushing to increase trade in RMB. Whilst only Hong Kong and Macau were allowed to offer RMB trade settlement during the pilot scheme stage, regulators have since liberalized the current account and the RMB can now be used for trade in any market. Although the RMB is not yet fully convertible, pro-active steps have been taken by regulators towards that direction, promoting RMB as an alternative trading currency to the international trade community.

In May 2013, the State Council of China announced that it had developed a roadmap to open the capital account, which is important because liberalization of the capital account will allow RMB to be moved freely into and outside of China. Liquidity for RMB transactions in offshore markets will also be supported by the ongoing efforts of The People’s Bank of China to establish bi-lateral currency swaps with Central Banks.

The changes in regulations have put in place the possibility of the RMB becoming an alternative to U.S. dollars and the Euro for international trade. Whilst the U.S. dollar is the dominant currency for trade in the United States and several parts of the world, and the Euro is dominant for trade with Europe, there is yet to be a similar dominant currency for trade in Asia. The RMB could possibly become that anchor currency. It is envisioned that in the foreseeable future, non-Chinese counterparties without a foothold in China such as corporates conducting trade between Hong Kong and Singapore, or even Korea and Brazil, could use the RMB instead when trading internationally.

Support for International Trade in RMB

As financial institutions and corporates look at conducting trade in RMB, they need to ensure that they have support from their banking partner(s).

Financial institutions need to continue to support multiple currencies, since the RMB may remain just one of the many currencies that their corporate clients use for international trade. Corporates can benefit by selecting a global bank with a broad geographical coverage and full service capabilities, to support all the trading currencies they need. Financial institutions in offshore markets that do not have strong capabilities in RMB can benefit from collaborating with a global bank that offers full capabilities, as well as thought leadership, education and sharing of best practices.

Financial institutions and corporates alike can benefit from working with a global bank that has a RMB strategy, investments to support the strategy, access to regulatory and market updates, new trade products to support their needs, and the innovation to keep them at the forefront of their industry.

Jacques Ling is Executive Director and Senior Product Manager at J.P. Morgan Treasury Services. Based in Hong Kong, he is responsible for the regional product development, management and implementation of Trade Finance in Asia Pacific. With over 20 years of experience in the banking industry, Jacques has held various roles in international banks in Singapore, with a focus in Trade Finance and transaction banking. He is also a member of the International Chamber of Commerce – Hong Kong, China.
Renminbi (RMB) cross-border payments are growing rapidly, and regulators are changing policies as well as developing new technology to enhance cross-border payments. Corporates can leverage on these changes, and they also need to be ready to take advantage of upcoming changes in the near future.

With constraints on cross-border payment processing and ongoing regulatory changes in China, multinational corporations (MNCs) are applying payment and treasury center best practices to enhance payment processing efficiency, and manage foreign exchange (FX) risks more effectively for RMB cross-border transactions.

The Evolution of Cross-Border Payment Processing

Payments in RMB for cross-border trade settlement first started in 2009, after the People's Bank of China (PBOC) opened up the currency for international trade, and usage expanded in 2010 when the PBOC allowed investments using RMB. Trade settlement using RMB, whilst growing quickly, has been hampered by burdensome requirements, however, as regulations required verification of the authenticity of the underlying trade and reviews of a multitude of documents, including customs declaration forms, invoices and sales contracts.

The PBOC issued the latest guidelines on simplified requirements for RMB Cross-Border trade settlement on 10 July 2013, allowing banks to process RMB cross-border payments with simpler trade documentation requirements. Whilst these guidelines did not completely remove all the documentation required, it did provide for a consistent stance across the nation. Corporates that are not on PBOC’s List of Enterprises Under Close Supervision may be able to further enhance their RMB payment efficiency with documentation requirements being reduced.

Whilst the PBOC continues to introduce measures to further promote the acceptance of RMB in the international marketplace as the currency of choice for trade settlement, regulatory compliance can present some challenges. In China, responsibility for regulations and internationalization is diffused among the PBOC, the State Administration of Foreign Exchange (SAFE), the Ministry of Commerce, the Ministry of Finance, Customs and the State Administration of Taxes (SAT) agencies. Along with understanding the regulations, corporates need to recognize the different priorities among various agencies so that they can follow regulations appropriately, and be able to take advantage of the ongoing liberalization of capital account activities, exchange rates and interest rates.

Enhancing Payments Efficiency

Despite operating in a complex environment, more corporates are moving towards using the RMB for payments, and they are looking at how to apply best practices so that they can make processing more efficient immediately, and be well positioned for changes in the future.

One practice corporates are using, particularly when they have RMB payables and receivables, is to set up a specialized team in Regional Treasury Centers (RTCs) to manage centralized payment processing, or to develop complex structures such as a Payments Factory to facilitate the central management of RMB onshore and offshore. Although Hong Kong and Singapore are still preferred locations for RTCs, more corporates are setting up RTCs in China to
One practice corporates are using, particularly when they have RMB payables and receivables, is to set up a specialized team in Regional Treasury Centers (RTCs) to manage centralized payment processing, or to develop complex structures such as a Payments Factory to facilitate the central management of RMB onshore and offshore.
take advantage of the RMB collected through their organic growth in the China onshore market despite the hurdles of capital account controls and higher tax rates.

In the offshore market, corporates are also working towards including RMB in their centralization of payments, so that a payment center offshore or treasury center overseas can make consolidated payments on behalf of other affiliated entities when paying into China. It will still take time for corporates to fully achieve greater efficiency, however, because there are regulatory requirements to monitor and report cross-border trade settlement transactions with each of the overseas trading entities and not just with one overseas RTC.

**Risk Mitigation**

Along with working to increase payment processing efficiency, corporates are increasingly focusing on risk mitigation, and three risks are particularly important.

Firstly, corporates are focusing on resolving the regulatory risk caused by the multi-layered responsibility for international payments transactions among PBOC, SAFE and the other agencies, and on determining whether solutions that they would like to implement are actually feasible. Corporates are either enhancing their internal capabilities or working closely with their banking partner to understand and address these regulatory risks.

Secondly, operational risk in foreign exchange management and processing remains a concern; particularly since the majority of corporates often settle in other currencies, lacking experience and understanding of the various controls and limitations related to RMB. Corporates are working to define strategies to manage offshore RMB, often in partnership with their global bank, so that they can ensure that their treasury teams as well as overseas customers and suppliers, are managing foreign exchange effectively and are prepared for any changes downstream.

Finally, corporates are setting up structures for hedging FX risk, as the continuing trend of RMB appreciation may result in additional FX costs, particularly when importers or exporters have costs and expenses domestically in RMB, whilst their contracts with overseas purchasers or sellers are in U.S. dollars or other currencies. Whilst some corporates have been able to mitigate FX risk by switching their payment currency to RMB, so that payables and receivables are in the same currency thus achieving some natural hedging, tools to manage FX risk in China remain limited and corporates are working with their banking partners to develop additional risk hedging tools that can enable them to manage their FX exposure more effectively.

**Leveraging Global Banks**

Given the complexity of the payment environment in China, an increasing number of corporates are leveraging their global banking partners more so that they can navigate the environment effectively and take advantage of the bank's thought leadership. Corporates can work with their global bank to obtain the latest trends and developments in RMB payment processing in China, enhance their internal processes to support RMB payments, and focus on the specific issues that are most important to their treasury functions. Global banks can also support corporates in making sure that the complex details for processes such as centralized payments meet regulatory requirements, helping corporates understand the banking system, and leveraging their relationships and global platforms to help manage payments inside and outside China.

One additional opportunity for corporates comes from leveraging a global bank's contacts to present their views to government agencies that may not be fully aware of the constraints of some of the required processes, or to conduct workshops that enable corporates to explain their unique situations and business needs in a neutral forum.

In an environment of constant change and diffused responsibilities, drawing on the experience and expertise of a banking partner can benefit corporates doing business with China tremendously.

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**Jiwei Ye** is Executive Director and Head of Multinational Corporate Sales, China at J.P. Morgan Treasury Services. Based in Shanghai, Jiwei provides treasury services solutions to corporates with a key focus on operational efficiency and working capital optimization, and he has a comprehensive knowledge of regulatory and operational best practices. Prior to his current position, Jiwei held various banking and corporate management roles in the United States and China, including as General Manager for J.P. Morgan Chase Vastera International Trade Consulting (Shanghai) Co. Ltd.

**Tse Fungwong** is Vice President and Product Manager of Global RMB Clearing for Treasury Services at J.P. Morgan. Based in Shanghai, Tse manages the end-to-end development of RMB treasury services products. Prior to joining J.P. Morgan, Tse held various product and project management roles in the United States and China, and was previously the Marketing Director for Aegon USA and Senior Business Analyst at Toys R Us International.
For more information, please contact your J.P. Morgan representative or visit us at jpmorgan.com