J.P.Morgan

Internationalization of the Renminbi –

What is the opportunity for banks?

Since China made initial steps in liberalizing its currency in 2009, much debate has continued over the renminbi (RMB) becoming a major reserve currency let alone a trading one. The ongoing sovereign crisis and in particular the recent credit downgrades of the US and Japan have increased the debate even further. While trade flows in and out of the country only seem to be heading in an upwardly direction, the internationalization of the RMB is front and centre in many conversations with the corporate treasurer.

It should be standard business practice for a financial institution to recognize the potential that this new opportunity (in terms of access) has to offer. The RMB is set to become a major global currency and at some point will probably account for a considerable proportion of central bank reserves. The time scale of such a change is yet to be determined as further work is needed from the Chinese authorities in terms of restriction over free float and conversion.

Economists today still view the RMB as an emerging market currency but many agree that in as little as 10 years, it could go as far as to succeed the US Dollar as the world's reserve currency.

Given the continual economic importance of China in the world economy, and the increasing trade flows, supporting the settlement of RMB transactions allows banks to tap into an ever growing market and generate a stream of revenue.

This paper reviews the challenges and possible solutions for banks that are facing a growing demand for services from their corporate clients operating and/or doing business in China.

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The Challenge

Under the onerous demands of an increased regulatory environment, tightening margins on income, and forced expectations of domestic priorities, banks in the West are facing significant challenges to maintain expected returns for their shareholders. In an effort to meet all of these challenges, many are looking to explore opportunities to generate streams of revenue from other sources while continuing to mitigate further public scrutiny of their international investments. As the banks' underlying corporate clients continue to look to expand their own customer and/or supplier base, many financial institutions are finding it difficult to meet these growing and global demands while balancing their own domestic expectations.

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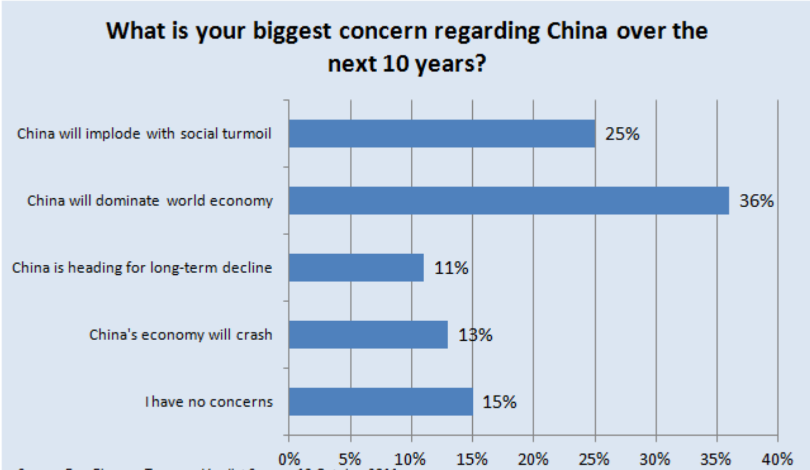
Many companies are finding that their trade counterparts in China are being encouraged by the PBOC for settlement to be made in RMB. Furthermore, many corporates outside China are realizing the benefits of an RMB price (highlighting distinct unit costs) as opposed to an FX adjusted price in USD. As a consequence, companies are looking towards their chosen bank to assist in the enablement of doing business in China and making settlement locally.

The Banks' role

It is of paramount importance that banks can deliver the services their clients need today with an optimistic eye on meeting future requirements. One might even go further and suggest that it is now a matter of survival for many banks to adopt a strategy to meet these demands as the East and West continue to come together.

[1] Hong Kong - The premier offshore renminbi business centre, HKMA report, 2011)



Source: EuroFinance Treasury Verdict Survey, 13 October 2011

China has already taken three steps towards the internationalization of the RMB:

1. International trade settlement in RMB has been significant. In July, 2011, The People's Bank of China (PBOC) reported Year-To-Date CNY1000.1 Bn which is nearly double the 2010 total of CNY506.3 Bn.
2. The issuance of RMB-denominated bonds in offshore markets to create investment opportunities and to build liquidity offshore; Hong Kong issued CNY 50 billion dim sum bonds by the end of July this year. (CNY denominated bonds in Hong Kong) [1]
3. The establishment of RMB offshore centers, with Hong Kong leading, and there's heated competition from other cities such as Singapore and Taipei. London has hopes to follow as this September (2011) China gave formal backing for it to be another offshore financial center.

J.P. Morgan has witnessed a small number of progressive Multinational Corporations (MNCs) that are keen to explore new arrangements to take advantage of China's desire and initial steps to internationalize RMB. Many though have yet to take a leap of faith and would prefer to adopt a wait and see approach as they look for further momentum before they change their internal processes.

In a recent "Treasury Verdict" live poll conducted by *EuroFinance* and supported by J.P. Morgan, 49% of the 600+ treasury professionals in the audience, (most of who are operating in Europe), cited social and economic concerns over China within the next ten years. Clearly there is still some pessimism from the European corporate treasury community as to whether China can sustain its growth rates and may be a factor as to why the MNCs are not as proactive in this space.

Most of the traction to use RMB is currently being generated from Small and Medium sized Enterprises (SMEs) who might not be as restricted as a Fortune 500 company in quickly taking advantage in leveraging new opportunities.

Today, large companies have not moved wholesale and changed their supply chains to integrate the RMB currency due to a lack of practical capability to integrate the currency into their workflows. Additionally, it remains to be seen whether Treasurers are ready to take on the foreign exchange risks by invoicing in RMB, especially with the currency still expected to appreciate, albeit at a slower pace.

Should Chinese importers however become even more aggressive towards dictating trade settlement terms, one might discover the lukewarm response from those larger MNCs becomes much warmer, especially when conversations have taken place with their procurement and sales departments about the opportunities that China undoubtedly offers.

Nevertheless, SMEs and MNCs alike will turn to their banks for proactive dialogue to help them achieve their ambitions with China.

What a Corporate needs

The RMB presents a major opportunity in delivering services a corporate will need to fulfill the daily treasury and cash management requirements of their global operations.

From procurement through to sales via treasury, banks need to deliver a full suite of services that overcome the challenges the corporate is faced with. Any well managed corporate will need to hedge its foreign currency exposure as well as make the most efficient use of its liquidity both in terms of raising funds and investments.

Although regulations are changing rapidly in recent times, the following have become more critical for any corporate trading with mainland China:

- To be able to make trade settlement transactions in RMB is a prerequisite
- To receive up to date information on market changes, specifically related to regulation, and guide them through the complexities of trading in RMB
- The ability to hedge FX exposure
- To invest short-term liquidity in RMB and be able to put a long-term strategy in place for future requirements
- Trade services, in particular local Letter of Credit expertise to understand the stringent compliance legislation associated with China

How Banks can meet the Corporate needs

To support the needs of their clients, banks need to be able to support most, if not all of the evolving global treasury and procurement requirements of a corporate. It is no longer sufficient just being able to support the domestic needs of a corporate client. In the recent EuroFinance "Treasury Verdict" live poll that was supported by J.P. Morgan Treasury Services, only 16% cited Europe as the area of future growth.

While the proverbial global virtual village allows even the consumer to buy direct from any country in the world that accepts a credit card, delivering solutions to a corporate is far more a Global proposition than it has ever been. The question is how to efficiently and effectively support corporate client needs in China?

The most obvious answer is to open a branch. However, this in itself has a multitude of challenges associated with it, from the

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investment required to take on such a task all the way through to some banks having to manage public scrutiny of those investments outside of their domestic markets.

Furthermore, time to market is lengthy, leaving the competition the opportunity to secure business. Let us not forget that China has gone on to build well capitalized banks themselves who are rapidly expanding their own global presence. What many banks used to consider competition has taken on a new meaning in recent times.

Leveraging a global bank relationship is a viable solution. This allows banks to utilize the capabilities of the institution quickly and effectively without any significant financial investment.

Furthermore, leveraging the local expertise of that provider becomes a powerful asset to shorten the learning curve and understand the ever changing regulations in China.

Criteria required in selecting a chosen RMB Bank

The key considerations that banks need to investigate in choosing their RMB bank provider are:

- Eligibility – Does the RMB bank have approval as a Mainland Correspondent Bank in China, Participating Bank status in Hong Kong or regulatory approval from the Taiwanese authorities?
- Capability – Can the RMB bank offer the local capabilities such as direct access to local clearing?
- Presence - Does the RMB bank have local presence in mainland China and Hong Kong today and a presence in any potential offshore centers China may choose?
- Solutions - Does the bank offer a full suite of services, from in country account, cross border trade settlement service, FX hedging, investments and liquidity solutions?
- Expertise – Does the RMB bank have local expertise around market practices and procedures? Do they have relationships with local banks to gain a deeper understanding when needed?

  Is the RMB bank proactive in guiding its banking clients through the complexities of local regulations or does it view its clients as a competitor as well?
- Dependable and consistent service – Does the RMB bank deliver responsive service to handle any issues in the local markets? Is the RMB bank proactive in assisting with implementing a solution? Is client service in a suitable timezone and language and able to retrieve information quickly?
- Consultancy style approach - Should RMB accounts be in more than one province of China or just Hong Kong? What are the challenges in opening accounts for trade settlement versus FX hedging and/or liquidity strategies? Are there mechanisms in place of avoiding cash being trapped?

The Internationalization of RMB clearly presents an opportunity, but are the Banks ready to grasp it? Liberalization is by no means yet complete, and challenges still remain, but by working with the right global banking partner that can understand and address the company's regional and global needs, banks can implement a flexible strategy by which they can take advantage of continuing deregulation.

Demand for RMB services by corporates on their banks will intensify over the coming years. Fittingly, Confucius once said "When you have faults, do not fear to abandon them". While opportunity exists, the time is right to leverage a relationship that can deliver the opportunity.