



The Rise and Rise of CNH

For Corporate Clients

INDUSTRY INSIGHT



The continued growth of China has made it the world's second-largest economy. Corporations doing business in China or with China are reviewing their strategic and financial objectives to capture new opportunities. There has been a great deal reported in the media about the fiscal and currency reforms that are gradually being introduced by the Chinese authorities. For example, the RMB cross-border settlement scheme, launched in 2009, now enables companies of all sizes to settle cross-border transactions from entities in any country with a growing list of designated mainland enterprises in RMB. However, although progress towards currency and regulatory liberalization has been relatively rapid, rigorous controls still exist, so treasurers should be realistic about their business and financial needs before considering whether to start buying, selling, or investing in RMB.

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RMB, CNH or CNY?

Although RMB traded onshore in China and offshore in, for example, Hong Kong is the same currency, it has different exchange rates as it has different supply and demand conditions. Consequently, separate currency codes have emerged to represent onshore and offshore RMB: CNH is used to represent the exchange rate of RMB that trades offshore in Hong Kong; CNY is used to represent onshore RMB within China.

In addition to these, there are also different exchange rates used for non-deliverable and deliverable forwards. It is important to note that in order to promote cross-border trade flows in RMB, the PBOC has made available the CNY rate for qualified transactions under the RMB cross-border settlement scheme. This means currency conversion for qualified transactions can occur either at the interbank CNH rate or at the onshore CNY rate (sometimes also referred to as CNT).

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RMB Offshore Trading Opportunities

In reality, pricing cross-border trades in RMB is nothing new: for some time prior to the launch of the cross-border settlement scheme, larger corporates in China with sufficient negotiating power had been pricing their sales to foreign customers in RMB, and demanding that foreign suppliers did the same. At the point of settlement, the buyer generally paid the amount in an agreed foreign currency (e.g. USD) based on the settlement date exchange rate. There were even letters of credit being issued in RMB, with settlement in foreign currency equivalent, which can now be settled in RMB.

Therefore, the RMB cross-border trade settlement scheme is in many ways a logical progression of accepted business practices. The scheme is part of the Chinese government's long-term objective to have the RMB become an international currency, ultimately for trade, investment, and as a reserve currency. One of the first steps in achieving this was enabling trade transactions to be priced and settled in RMB. This undoubtedly offers advantages in some cases. For example, offshore sellers can use RMB receivables for their RMB payables (whether onshore or offshore), creating a natural hedge for their FX position and protecting margins.

Some companies will also take the view that holding RMB will ultimately be beneficial, as the market predicts a long-term strengthening of the currency. The rapid growth in the institutional deposit base (USD315 billion in December 2010, HKMA) reflects both an acceptance and a desire to denominate trade in RMB and hold RMB offshore. However, CNH held by foreign corporations outside China cannot easily be transferred into China except for making cross-border supplier payments, so the inevitable problem is what they should, or can do, with cash held as CNH.

Beyond RMB Trade

Since July 2010, CNH has been a deliverable currency in Hong Kong. So one option is to exchange CNH into other currencies, such as USD, EUR, JPY, and HKD. While spot, forward and swap transactions are possible (either as a deliverable forward via the Hong Kong interbank market or as a non-deliverable forward elsewhere), there are far more restrictions than for CNY.

Effectively, a currency of trade is of greater use if it is also a currency of store. To achieve this, there needs to be a return on capital. A second step towards currency liberalization is the development of CNH investment instruments, which, again, typically originate in Hong Kong. The range of investment products is still limited compared with other currencies, although it is steadily growing. The first CNH-denominated offshore mutual fund was launched in August 2010, and the CNH bond market is growing in Hong Kong. Certificates of deposit can be traded, and some structured products exist. With CNH-denominated investment instruments often offering a better return than those in other currencies (although typically lower than domestic investments in China), together with a growing range of money market instruments from the CNH interbank market in Hong Kong, the investment opportunities for companies with growing CNH balances are expanding.

The CNH market is still less sophisticated than for CNY or other currencies, however, and investing in long or short-term investment instruments does not necessarily address the problem of how to use this cash. Ultimately, unless a foreign company has both cross-border payables and receivables in RMB, or wishes to take a long-term view of currency appreciation, there is little benefit to switching earnings from another currency, unless there are strong commercial considerations for doing so. However, there has also been significant attention given to RMB financing, both CNH and CNY. For example, both McDonald's and Caterpillar have launched RMB-denominated bond issues in Hong Kong, in August and November 2010, respectively. In Caterpillar's case, although the bonds were issued offshore, the company received permission to transfer the cash into China to support customer financing and leasing. In addition, we are also finding that our customers may be seeking to draw down financing facilities in CNH, with a view to financing China-based entities if they can obtain permission to do so.

Capabilities in CNH

- Two-way cross-border trade of goods and services can be conducted from companies located in any country globally with mainland designated enterprises in 20 provinces and municipalities in mainland China, of which there are over 67,000.
- CNH can be accumulated in any country, but only in Hong Kong is it physically deliverable. It is also the only location in which RMB trading is officially sanctioned.
- Companies can invest in “real” assets (as opposed to derivative instruments) such as deposits and bonds. In the future, this is also likely to include equities.
- CNH-denominated money market funds now exist in Hong Kong for diversified holdings of CNH for both short- and longer-term investment.
- We are likely to see continued interest in, and regulatory support for, CNH bond issuance, by Chinese and multinational corporations as the existence of a deep, liquid bond market is an important step in achieving an international reserve currency.
- CNH can typically be included in multi-currency notional pooling.

The Wider Implications

So what do these developments tell us? Firstly, the evolving of CNH in its own right brings opportunities for some companies, particularly those with equivalent RMB assets and liabilities. For others, there is a potential issue of currency risk, which, like every other currency exposure, needs to be managed. In the case of CNH, the opportunities for doing so may be more limited than for other currencies. Some companies will welcome this exposure, but for corporate treasurers, this is rarely the objective.

Secondly, the development of CNH with its own exchange rates and forward curve creates potential conversion opportunities back into USD, for example, where the value may be higher than CNY. While regulators are attempting to minimize this mismatch, there may be opportunities for certain market participants in the meantime.

Thirdly, with limited liquidity in the global markets, many companies are seeking to expand their borrowing options. Consequently, the ability to access a new group of potential lenders and investors in Hong Kong and use this cash to fund operations in China (subject to approvals) may bring considerable additional opportunity for growth.

Centers for CNH

Hong Kong has developed rapidly as the center for CNH. Not only is the territory a benchmark for other countries for cross-border trade in RMB, but it also offers considerable additional opportunities over other locations. In Hong Kong, cross-border trade settlement can be cleared through both onshore correspondent banks and the local clearing bank, which is not possible elsewhere. Domestically, CNH is an entirely free currency for corporate, and Hong Kong is the only offshore jurisdiction that has a real-time local clearing system for RMB. CNH accounts can be held for any purpose, as opposed to being restricted only to trade-related flows, and there are no limitations on transfers between offshore accounts, thereby creating a CNH interbank market in Hong Kong. The range of financial products in CNH is increasing far more rapidly and proactively than in other markets and liquidity levels, and the amount of CNH fundraising and debt issuance is substantially higher. Consequently, Hong Kong is increasingly the natural choice both for companies engaging, or seeking to engage, in CNH business and as a gateway to Asia. As market liquidity continues to increase, and the range of instruments develops further, this dominant position will strengthen further. For example, with RMB funds now becoming popular, it is likely that RMB-denominated equity will shortly be available.

In addition, we are now seeing Singapore emerging as an active market place for CNH, with a number of banks announcing new RMB-denominated products in recent months, both for institutional and for retail customers. Encouraged by the Sino-Singapore currency swap agreement in 2010, multinational corporations already well established in Singapore are likely to see significant new opportunities for RMB investment and borrowing in the future, in addition to RMB trade transactions, in which Singapore is already very strong.

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Engaging Clients, Providing Clarity

China is playing an increasingly important role in the global economy; however, significant currency controls and regulatory restrictions on the transfer of capital remain, and few treasurers will find there is strategic advantage in hurrying to adopt a new currency.

For treasurers with sizeable activities in RMB in particular, it becomes paramount to keep abreast of regulatory changes, which is not always easy in a fast-changing landscape. This necessitates a professional banking partner who can ensure that the right solution is in place to meet the needs of the business while it complies with necessary regulations. At Citi, we are focused not only on delivering the CNH and CNY foreign exchange, liquidity, investment, borrowing, and trade solutions that our clients require, but also on leveraging our expertise and unique access to regulators to provide information and clarity on the changing regulatory picture. For example, we provide frequent updates, webinars, and events at which regulators are invited to present to our clients, providing first-hand news and expertise. By gaining access to the right information, and benefiting from our pragmatic approach, treasurers can take advantage of opportunities at the right time for their business, without taking unforeseen risks or falling afoul of regulations.

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