



Stepping Stones to a Successful Treasury Operation in China

For Corporate Clients

INDUSTRY INSIGHT



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China continues to be a huge draw for multinational corporations (MNCs) seeking to expand in Asia Pacific. No matter which industry they operate in, companies are developing growth strategies allowing them to participate in and benefit from one of the world's fastest-growing markets. MNCs know the importance of increasing their presence on the ground in China, and in many cases are rushing to compete with rivals with better-established footholds.

As they expand and develop the business structures necessary to support this growth, MNCs used to a single global or regional treasury policy will find China a unique case and treasurers will face multiple challenges in dovetailing Chinese operations into an existing treasury function.

For example, it can be difficult to repatriate cash to overseas headquarters, without understanding the regulations that govern the repatriation of proceeds from Chinese subsidiaries. Centralized treasuries also face challenges such as maintaining control of their subsidiaries, managing multiple bank relationships, and improving cash management to free up liquidity from China.

To navigate these challenges successfully, treasurers must act early to learn and understand how best to manage profits generated by their Chinese entities. MNCs can also benefit from the range of treasury solutions available to help ensure the success of their operations in China.

Treasury Control Over Subsidiaries

MNCs may need to modify existing global or regional treasury policies for their Chinese subsidiaries. For example, netting is not allowed in China. Chinese subsidiaries of an MNC with global netting arrangements can only participate by following their global netting calendar and settling with their respective overseas inter-company contract parties via a gross in and out approach.

Similarly, MNCs may not be able to centralize their Chinese FX transactions and hedging activities at treasury centers or in-house bank overseas, due to restrictions on passing on a gain or loss cross-border to their subsidiary operations. So to ensure a Chinese subsidiary is effectively hedged, MNCs may need to hedge onshore, requiring changes to treasury policies and credit line allocation.

In addition, in some industries that require an MNC to form a joint venture (JV), companies may find their local partner unwilling to surrender control to a centralized treasury center, even if they hold a minority position in the JV. Treasurers may also face resistance from subsidiary companies and even peers in other corporate functions because the concept of centralization is still a relatively new one in China.

To succeed, MNCs may need to alter their approach in China, modify global policies, operate a certain level of decentralized treasury functions for China, and create a separate structure for Chinese subsidiaries. Companies should also give careful attention to cash management: reducing cash flows into China, and planning how best to repatriate cash to overseas affiliates.

Bank Relationship Management

It is a common practice for MNCs to rationalize their relationship banks, as the use of too many banks adds to daily operations and risks. However, in a market like China where subsidiary operations need regular access to cash; original supporting documents are required for cross-border payments; and companies are often assigned a preferred bank for tax payments by local authorities, MNCs have to deal with local banks that are sometimes outside their treasury's preferred banking list.

Yet, the situation does not have to be a negative one. While foreign banks provide support to MNCs' regional or global operations, local banks can also supplement their China business. There are over 10,000 local banks in China, most of which are too small to have a credit rating deemed acceptable by an MNC's investment policy. But the four biggest state-owned banks and a few other major commercial banks with nationwide coverage can provide good on-site services to MNCs in China. Not only do these local banks have acceptable credit ratings, but they also offer greater nationwide coverage and, sometimes, an even better credit appetite than foreign banks limited by lending quotas related to their size in China.

However, treasurers who have been used to smooth communication channels and one global point of contact with a foreign bank may need to adapt to dealing with a local bank that lacks nationwide branch coordination, and whose staff are sometimes less sophisticated at cross-selling and devising tailored solutions. Foreign banks, aware of the limitations of their network presence in China, are therefore leveraging their e-banking capabilities and forming alliances with local banks to support MNCs' payment and collection requirements.

So, to put in place an optimized relationship management strategy in China, MNCs should first assess their own needs to ensure they can then trade off the strengths each bank can offer.

Cash Management

The first step in a good cash management program is for treasurers to have visibility of their cash balance across subsidiaries - normally achieved via a treasury management platform to capture and consolidate banks' MT940 reporting of daily balances. But as smaller local banks in China are less likely to offer MT940 reporting (or tend to charge high rates if they do), treasurers needing this service may have to conduct discussions with local banks on a branch-by-branch basis. Banks who have built host to host connection with other alliance banks in China may assist clients to speed up the process to some extent.

Many MNCs also choose to adopt a cash concentration structure to reduce group leverage in China. With such a structure, domestic RMB or foreign currency pools can be set up under an entrustment loan framework that requires inter-company lending to be routed through an agent bank. Although there were concerns about this structure when the Thin Capital Rule of 2:1 was first introduced in China in 2008, it has since been confirmed that as long as the interest rate is set on an arm's length basis, the interest expense of any amount exceeding that ratio is still tax deductible. However, multi entity notional pooling is not yet available in China.

Another key area of cash management is to ensure that MNCs are receiving an optimal return on deposits. In China, the RMB deposit rate is regulated by the People's Bank of China, the central bank. As a result, treasurers often prefer to move balances to offshore markets where more investment options are available. For onshore balances, options other than bank deposit shall be evaluated carefully with MNCs' investment policy.

Cash Repatriation

An important consideration for MNCs operating in China is the issue of trapped cash. Currently, as Chinese entities are limited from participating directly in cross-border cash pooling platforms, treasurers may need to find other ways to repatriate surplus cash from China.¹

Commonly adopted repatriation methods include dividend payments, royalties, service fees and management fee allocations, all of which come with restrictions. For example, a dividend can be declared once a year following an annual audit, but there is a reserve requirement to Wholly Foreign-owned Enterprises (WFOEs) to retain 10% of their Retained Earnings from distribution until the accumulated reserve reaches 50% of its Registered Capital. Following China's 2008 Income Tax Reform, dividends are also subject to a withholding tax (WHT) of 10%, unless lowered by a Double Tax Treaty Agreement between China and the country where the overseas shareholder resides.

Depending on the specific needs of an MNC and its existing legal structure and business model, other repatriation solutions can be tailor-made to further reduce trapped cash in China, for example via trade or equity arrangements. In order to comply with all related regulations during the process, MNCs should consult their legal, tax and banking partners in advance.

Financing Business Growth in China

Most MNCs operating in China need continuous funding to support daily operations and business growth. But trapped cash concerns require them to plan their capital structure carefully when investing. While capital reduction is possible, it may be difficult to secure permission from local governments keen to maximize foreign direct investment. So it is important to set up the right level of equity - Registered Capital - for a new entity in China.

An entity's Registered Capital, as well as its Total Investment, must be indicated in the Feasibility Study to be agreed with a joint venture partner (if any) and submitted to the related government authority for approval before the entity's establishment. One well-known quota related to these two concepts is the Foreign Debt Quota of an MNC's Chinese subsidiary - the allowed future borrowing from overseas must be within the gap between its Total Investment and Registered Capital. So, treasurers who want to minimize equity investment into China by shareholder's loans should be mindful of its impact in advance.

Ideally, careful cash flow forecasting, improved working capital management, and an efficient liquidity management structure can help treasurers to better manage their cash; minimize cash trapped by reducing further cash inflows to China; and optimize funding solutions for future business expansion or M&A activity in China.

Changing Laws and Regulations

Like other emerging markets, China is well-known for its regulated environment. MNCs must therefore keep up to date with changing laws and regulations in China to maximize the efficiency of their treasury operations. For example, the rapid development of the RMB Cross-border Settlement Scheme demonstrates just how quickly and frequently the rules can change. In just two years, RMB has become technically ready to be used as a cross-border settlement currency for both current and capital accounts; the CNH market has developed in Hong Kong; and new rules for the program continue to be released by the central bank, driving further progress.

To solve the challenges faced by MNCs in achieving control and efficiency in their treasury operations in China, it will always be beneficial for treasurers to keep up a constant dialogue with legal, tax and banking partners, be open to learning best market practices, and be ready to think creatively and use innovative solutions to their treasury challenges.

¹ There is one exception, according to the Circular on Operating Procedure of Overseas Loans Granted by Foreign-invested MNCs in Pudong Area (No. 32 [2010] of SAFE Shanghai): Shanghai Pudong-registered MNCs can lend up to their unpaid dividend to their overseas affiliates, subject to SAFE approval.

The scheme not only provides flexibility on FX risk management for MNCs, but a deeper study of the regulation could also provide ideas to help treasurers solve trapped cash challenges, or gain access to cheaper financing overseas.

To ensure they are positioned to react quickly to take advantage of arbitrage opportunities before they elapse, companies should seek a banking partner able to provide timely updates on regulatory developments, and fully understand their business and needs in China.

Planning for Success

There is a famous quote from the "Art of War" by Sun-Tzu, a war master in China in around 500 BC: "Know your counterpart, know yourself, a hundred battles, a hundred wins." For MNCs operating in China, navigating the environment might at times appear an uphill task, but to succeed they need to pay extra attention to understanding both their own position and the surrounding business environment. To solve the challenges faced by MNCs in achieving control and efficiency in their treasury operations in China, it will always be beneficial for treasurers to keep up a constant dialogue with legal, tax and banking partners, be open to learning best market practices, and be ready to think creatively and use innovative solutions to their treasury challenges. Opportunity always favors the prepared mind.

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