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"PEELING THE ONION - Part 10"



Treasury Management in China

Corporate treasury management is a complex term. Loosely defined as the management of a company's monetary assets and liabilities, financial risks and banking relationships the term also encompasses processes of cash management, managing foreign exchange and interest rate exposures. It really is an onion with many different layers!

In China, as ever, things can be even more complex and the rules of treasury management are a little different from other parts of the world. In fact, not only are the rules a little different, a few years ago it might have seemed like a totally different game altogether. World Trade Organisation (WTO) entry may not be the miracle needed to revolutionise treasury operations in China, but companies are certainly starting to benefit from gradual improvements in the system.



The Problems in China

In assessing the various treasury management options currently available to foreign enterprises operating in China, it's important to begin by examining the inherent problems. First and foremost, and potentially the biggest hurdle to the continued growth of the Chinese economy, is the sick state of China's banking system. Just last week the head of the newly created China Banking Regulatory Committee declared that "time is running out for the banks."

Officially, non-performing loans in China's state-owned banks amount to about US\$500 billion, 25% of total outstanding loans, though this figure might be much higher, with some estimates as high as 50%. Whatever the case, China's banking system is dangerously weak. The Chinese government has suggested that China can simply outgrow these bad loans. This option however would put Chinese banks in an unfavourable position whereby they would be unable to operate according to international standards and also making banking reform increasingly difficult.

Not so long ago, cash management in China was a hair-pulling event. Couriers travelled miles, hauling bags of cash to settle payments. Progress has been made however following the implementation of a national inter-bank clearing system called the China National

Payments Network (CNAPS) at the beginning of 2000. Introduced by the People's Bank of China (PBOC), the country's central bank, there are now over 20,000 direct clearing members and 80% of the transfers arrive within twenty-four hours.

As foreign investment in China continues to grow, so will the demands of multi-national companies for banks in China to provide more efficient cash management solutions. The introduction of CNAPS has certainly made things easier but the banks still lack the level of sophistication and array of products available at foreign banks. A mainly paper based system means there are still delays in payments and collections. Most importantly, all foreign exchange dealings are still closely monitored by the State Administration for Foreign Exchange (SAFE).

Another obstacle to the efficient management of a company's cash flow is the regulations in China concerning borrowing and lending between different companies and even between subsidiaries of the same company. As far as cash management is concerned related companies are in fact very much unrelated. As such, subsidiaries with surplus funds cannot technically support subsidiaries in deficit, primarily due to restrictions of business scopes.



More Than Just a Survival Tool?

In Asia, most companies still view cash and treasury management as nothing more than survival tools; processes to ensure that payments are made on time and receivables are collected quickly to keep the business running. Why then is treasury management becoming increasingly important for companies on China?

The Asian economies have enjoyed something of a roller coaster ride since the financial crisis of 1997. Treasurers in China need to prove they can manage their assets around the risk provided by such a turbulent economic environment. In short, managing such risks are essential in order to minimise future cash flow problems and provide for careful financial planning and forecasting. It is important for foreign companies in China to identify those risks that offer the biggest threat and implement a system of tracking such risks.

Generally companies are not in the financial risk game. Rather, depending on the nature of the company's business, the primary concerns, particularly for the treasury department, will be to minimise interest costs while at the same time managing financial risk within limits established by senior management or the board of directors.



China as a Treasury Hub?

One sign that corporate treasurers are beginning to get serious about China is a readiness to set up regional treasury centres in the country. Regulations concerning the development of regional headquarters in Shanghai issued in July 2002 stipulated that Shanghai headquarters would benefit from further regulations designed to improve their efficiency in cash and treasury management in the future. When, in October 2002, JPMorgan announced the introduction of a full range of RMB services in four Chinese cities by 2003, the bank also announced the introduction to China of its global risk management tools and capabilities. JPMorgan's Chairman for Asia Pacific declared:

“With the increasing challenge of competing in a global environment, Chinese enterprises and foreign-invested entities require more sophisticated and effective asset and liability management tools to reduce their funding costs and financial risks as well as to increase cash management flexibilities. The current environment of low interest rates, weak equity valuations and high foreign exchange volatilities provides the ideal backdrop for the introduction of these new services.”

The creation earlier this year of a new independent banking regulator has left the Central bank, PBOC, free to concentrate on monetary policy, and in particular on the much-needed liberalization of interest rates. The government also seems keen to revive its programme to clear up the bank’s bad loans, and late last year allowed Goldman Sachs and Morgan Stanley to form joint ventures with one of four asset management companies set up in 1999.



The Growing Demand in China

It’s apparent then that in the current economic environment, demand for more efficient cash management and treasury services in China is on the rise. Just as the introduction of an inter-bank clearing system helped to ease the restrictions in moving cash, so have other barriers fallen by the wayside. Finance managers in China are discovering that strategies to get around the problems do exist. Previously companies would bypass the restrictions on inter-company loans through back-to-back loans. Under this arrangement a company in surplus would deposit a sum of money to a bank, which would then lend the same amount to the depositor’s related company, at commercial interest rates.

Recently however, company’s have taken advantage of a WTO concession to introduce a new financing scheme called entrust loans.. Under the scheme one subsidiary can lend its own funds, at its own interest rate, to another subsidiary. All the former subsidiary has to do is entrust a bank that will deliver the funds to the latter. Entrust loans are cheaper since the former subsidiary determines its own interest rate, and only pays the bank an administrative fee of about 0.5 percent of the loan amount. As one CFO in China explained, it’s just like transferring funds from my left pocket to my right pocket.”



Alternative Strategies

In China it is also common for foreign companies to have multiple sales branches scattered throughout the country, collecting sales products locally, resulting in idle balances left in branch accounts and inadequate central control over branch bank accounts. These issues can be addressed via establishing a sweeping structure whereby all branch offices open collection accounts with one foreign bank.

If a particular branch is located outside of a foreign bank’s permitted area of RMB business, then the foreign bank should arrange to open a collection accounts with a partner local bank. Headquarters should set a minimum branch account threshold and when the funds in a branch account fall below the minimum amount, they will automatically be swept to the company’s main concentration account.

Currency risk represents a considerable threat to a foreign companies operating in China since the RMB is non-convertible on the capital account. The PBOC has been so far reluctant to launch RMB derivatives instruments on domestic interest rates and currency, partly due to concerns about the stability of the onshore market. Currently the only RMB derivatives product available to domestic and foreign companies is a six-month RMB forwards market.



Hedging in China is primarily designed for short term trade related purposes, to lock in payment for imports, for example, and the size of the trade is limited to the value of the imported or exported goods. Documentary evidence and proof of payment must be provided which can prove problematic if the company does not receive an invoice in time. As long as the documentary evidence is procured however, the market functions satisfactorily.

An alternative option in China since foreign exchange is strictly regulated by the central bank is the non-deliverable forwards (NDF) market, based offshore and settled in US dollars. By some estimates, volume in the RMB NDF market has increased by 30% since China's accession to the WTO. Trading in the NDF market can be expensive however and most agree that a truly effective tool for hedging RMB does not yet exist. Foreign companies tend to use simpler strategies such as matching debts and assets, and sourcing products onshore to avoid currency risk. A large majority of profits in RMB generated by foreign entities are used to build the business and the infrastructure of the company's China operations. Elsewhere, companies are increasingly relying on RMB-denominated loans for projects in China to offset currency risk.

In order to further minimise risks resulted from deferred payment such as interest rate risk, currency risk, credit risk and political risk companies might consider forfaiting. A form of non-recourse financing, forfaiting is the discounting of an exporter's future receivables on a without recourse basis. Forfaiting helps to improve a company's cash flow because current trade receivables become current cash inflow and it helps the exporter improve its financial status and liquidity, whilst also enhancing the exporter's fund raising capability.



The Road Ahead

While utilising some of the above methods can help to considerably improve the efficiency of a foreign company's treasury operations in China, it's very clear that there is still along way to go. China's entry into WTO has made life that bit easier, but has by no means solved all of China's cash management problems. Cash management is becoming increasingly efficient, but maximising returns from excess funds is a still a tricky procedure.

A complete liberalisation of the market in the near future is unlikely and a great deal of uncertainty surrounds the future of the country's banking system. It is evident that, above all, any company looking to improve the efficiency of their treasury operations in China should first seek expert advice from a bank or a suitable business advisory firm.

Treasury management in China is changing rapidly. The road ahead will require a great deal of patience but offers potentially massive rewards.

"Peeling the Onion" is a series of newsletters designed to assist in the financial and accounting control of your China operations. We would love to hear what issues you would like to know about in coming articles, so please contact us with any questions."

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