ALLEN & OVERY

Generation ¥

RMB: the new global currency

The Economist Intelligence Unit

An Economist Intelligence Unit report, commissioned by Allen & Overy

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Foreword

China's currency, the renminbi (RMB), has well and truly arrived on the global stage, presenting both opportunities and potential risks that the many international companies engaged in the world's second-largest economy cannot afford to ignore.

While the currency's internationalisation has been well documented, less has been presented on what its rise means for multinationals, and how it is being successfully incorporated into corporate strategies. I am therefore delighted to present this paper, which we have commissioned from the Economist Intelligence Unit to address this gap.

Despite worries about China's slowing growth, there is every reason to believe that the renminbi's ascendance will not only continue, but also accelerate. While in the past this process was managed largely by policymakers, there are new drivers emerging on the demand side of the equation. China's foreign investment environment is likely to see significant liberalisation in the years ahead, encouraging more companies to invest in the country and giving them more incentive to use renminbi to extend their China operations. At the same time, the extension of financial technologies such as microcredit and e-commerce will enlarge the base of people within China who have access to money and credit. Consequently many more will be engaging in cross-border transactions, contributing to the currency's momentum.

In line with these developments, China's regulatory regime is being transformed to an extent that many multinationals will have to think about their treasury function differently. With the emergence of free trade zones, where the currency flows more openly, and regulators generally adopting a more

flexible approach, many of the old restrictions and constraints on which companies have based their renminbi-related decisions and strategies are fading away. Businesses should re-examine their treasury management practices in relation to their China operations, identify any deficiencies or gaps they were unable to address previously, and launch a new effort to look for solutions. They are likely to find regulators more willing to support this process. The increasingly active and largely open offshore renminbi market also provides companies with new funding and asset diversification options. Firms can also explore different channels for cross-border payments, staying alert to progress in the liberalisation of China's capital account.

Overall, the renminbi's internationalisation is a remarkable process that will contribute positively to both the development of the Chinese market and the operations of multinationals with a presence in the world's most populous nation. Rather than an arena of barriers to be confronted or circumvented, China's currency and foreign exchange regime is likely to be a source of new possibilities for those companies who keep abreast of the changes it is undergoing, and adjust their own policies in response.

Executive summary

The internationalisation of the RMB faces yet another milestone in October this year, when the International Monetary Fund will decide whether to include the RMB in its "virtual currency" basket known as Special Drawing Rights (SDR)[1]. The designation is arcane, even to many in business, but if the IMF grants the status central banks around the world will automatically recognise the RMB as a reserve currency, accelerating their RMB investment.

The IMF reviews its SDR portfolio every five years, and even if it decides to hold off granting the RMB SDR status (as it did in 2010), the currency will continue its steady march toward internationalisation regardless. In one indicator, the number of offshore clearing centres grew dramatically last year, when London, Frankfurt, Seoul, Paris, Luxembourg, Doha, Toronto and Sydney gained the status, followed in 2015 by Kuala Lumpur and Bangkok.

The rapidity of this advance means that to a manager of a P&L statement in a multinational company, coming to grips with managing RMB exposure in an era of change can seem like mounting a stallion without any real knowledge of how to ride it. Some learn quickly, others have to manage the jolts as best they can. Some 77% of the respondents to this survey say that little or no understanding within the firm about how to conduct RMB transactions remains an important obstacle to greater usage of the currency in cross-border transactions. That figure suggests many non-Chinese companies have been caught by surprise at the currency's international advance, but also that those that grasp the importance of sound management of their RMB exposures will be able to seize a competitive advantage.

Some results in this survey indicate this is happening already. Companies' usage of RMB is affecting their China strategies in many ways, from the way they manage employees, to their approach to entering new markets in China, and even to their global supplier networks. But the next stage of this strategic development is now just beginning: deployment of RMB competence as a component of global strategy. Companies will soon regard their management of the currency in the same way they regard management of the U.S. dollar, the euro and the yen. In emerging markets, where China is investing heavily, RMB competence may take prominence.

For so long, the RMB has been seen as a currency full of potential, with the brightest of international futures. For global companies, that future has already arrived.

1 Jukka Pihlman, "IMF decision could propel renminbi past sterling and yen", Financial Times Beyond Brics Blog, 15 December 2014

This research, conducted by the Economist Intelligence Unit and commissioned by Allen & Overy, examines how companies based outside of China are using the RMB and how that usage is changing. Key findings from the research, which focuses on corporate usage of the currency rather than investors' exposure to it, include:

– 90% of respondents say their company's current exposure to RMB is either important or very important to their business.

– More than 50% of non-Chinese companies use RMB for payments outside greater China: in Singapore (74%); South Korea (59%); the euro zone (58%); the UK (57%); and North America (54%), highlighting the extent to which the RMB is already being used for international trade outside of its home market.

– Almost two-thirds (62%) of companies currently using RMB in cross-border transactions expect the volume of transactions to more than double in the next five years. Over half (57%) expect their company's cross-border RMB transactions to grow by between 10% and 20% in the next 12 months.

– 77% think lack of understanding within their company about how to conduct RMB transactions is the greatest obstacle to their company's usage of RMB in cross-border transactions.

– Delays in the rollout of the China International Payments System (CIPS) is the clear number one regulatory issue holding back companies' use of RMB, according to 74% of respondents.

– Lack of overall RMB liquidity is the number one operational impediment to greater use of RMB according to 65% of respondents.

– This is also a major concern when assessing the risks associated with issuing both dim sum (off shore) and panda (on shore) bonds according to 70% and 51% of respondents respectively, citing insufficient liquidity in the secondary market as the risk that concerns them most.

– In terms of why companies outside China have decided to use RMB, no one reason stands head and shoulders above the rest, highlighting the broad appeal of the RMB. The most common reason is to lower transaction costs (45% of respondents put this factor in their top five); followed by lowering funding costs/cost of capital (42%); accessing new business opportunities (41%); broadening access to onshore buyers and suppliers (40%); and for timelier settlement (39%). Interestingly only 10% of respondents said their company had decided to use RMB to improve relations with Chinese government entities.

– The internationalisation and convertibility of the RMB has already had a considerable impact on companies' China strategies with 85% saying it has led to more investment devoted to mainland expansion plans (because of lower funding costs) and has also led to restructuring of global (71%) and regional (68%) supplier/vendor networks.

– Further liberalisation could possibly see companies relocating regional treasury operations to China and devolve more power to decision makers in the mainland, according to 64% of respondents.

– One change that is clearly going to have an impact is the introduction of new cross-border guarantee rules by the State Administration of Foreign Exchange. With the vast majority of respondents (81%) expecting it to provide better terms in lending arrangements for mainland units due to their company's credit rating being higher than its domestic credit rating. A further two-thirds (67%) say it will provide easier access to funding opportunities from local onshore financial institutions.

– The growth in use of RMB is not just a China success story. There is fierce competition among global financial centres to become the market of choice for RMB transactions. When it comes to RMB liquidity management outside Hong Kong, nearly as many respondents put the Shanghai Free-Trade Zone (78%) as Singapore (77%) in their top three locations of choice over the next five years. Interestingly, Luxembourg came next according to 52%, beating London by quite some margin at 33%.

Part 1:
The big picture

RMB: BUILDING VALUE FOR GLOBAL BUSINESS

China's currency, the RMB has become international with breathtaking speed: in January 2015 the Society for Worldwide Interbank Financial Telecommunication (SWIFT), an international financial messaging network, reported that it had broken into the top five global payments currencies by value, behind only the U.S. dollar, the euro, the British pound sterling and the Japanese yen[2]. In 2011 it was in 20th position and just two years ago it was in 13th place.

The dramatic rise in international usage of RMB is the result of steps taken by China's authorities to open up the country's financial markets. The free exchange of the currency across China's borders for trade-settlement purposes (i.e. an open current account) has been allowed only since 2009. Free flows in and out for other reasons (i.e. on the capital account) remain restricted, although Beijing has been taking gradual steps to allow more and more portfolio investment flows across its borders. Premier Li Keqiang reiterated the government's aim to make the RMB convertible in the strongest terms yet in his March 2015 report to the National People's Congress, saying simply, "China will achieve renminbi convertibility under capital account." The governor of the People's Bank of China (the central bank), Zhou Xiaochuan, later said this could happen in 2015[3]. For now, the currency remains split between onshore (CNY) and offshore (CNH) markets.

As the market for offshore RMB grows, non-Chinese companies' use of the currency is expanding and changing dramatically. For instance, although the first transaction currency for Volkswagen, the German auto manufacturer, is unsurprisingly the euro, the second is CNH – not the U.S. dollar – reflecting the company's high volume of sales in China[4]. CNH is also the second-most-used currency for its counterparts Daimler in Germany and Ford and General Motors in the U.S. Many sectors – from commodities producers to equipment manufacturers to service providers – have growing RMB exposures that match their longstanding and accelerating trade with China.

Indeed, competence in managing RMB exposure is now no longer just a "nice to have" but is essential to building value for global businesses.

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2 "RMB breaks into the top five as a world payments currency", SWIFT, 28 January 2015. In February it fell back to seventh place overall, but this was owing to the seasonal effects of the Chinese New Year holiday and February being a shorter month.
3 "China – RMB may become convertible in 2015", Deutsche Bank Research, 7 April 2015
4 Volkswagen press release, 11 January 2015

MOST COMPANIES THAT USE RMB SEE IT AS CRUCIAL TO THEIR BUSINESS

For those companies that use RMB the currency is increasingly crucial to their business, with 75% of survey respondents saying it is important and 15% calling it very important. This sentiment is in step with the rapid advance of the currency's usage offshore. SWIFT said in January 2015 that in the previous year global RMB payments grew in value by 102%, compared to an overall growth in transaction value for all currencies of 4.4%.

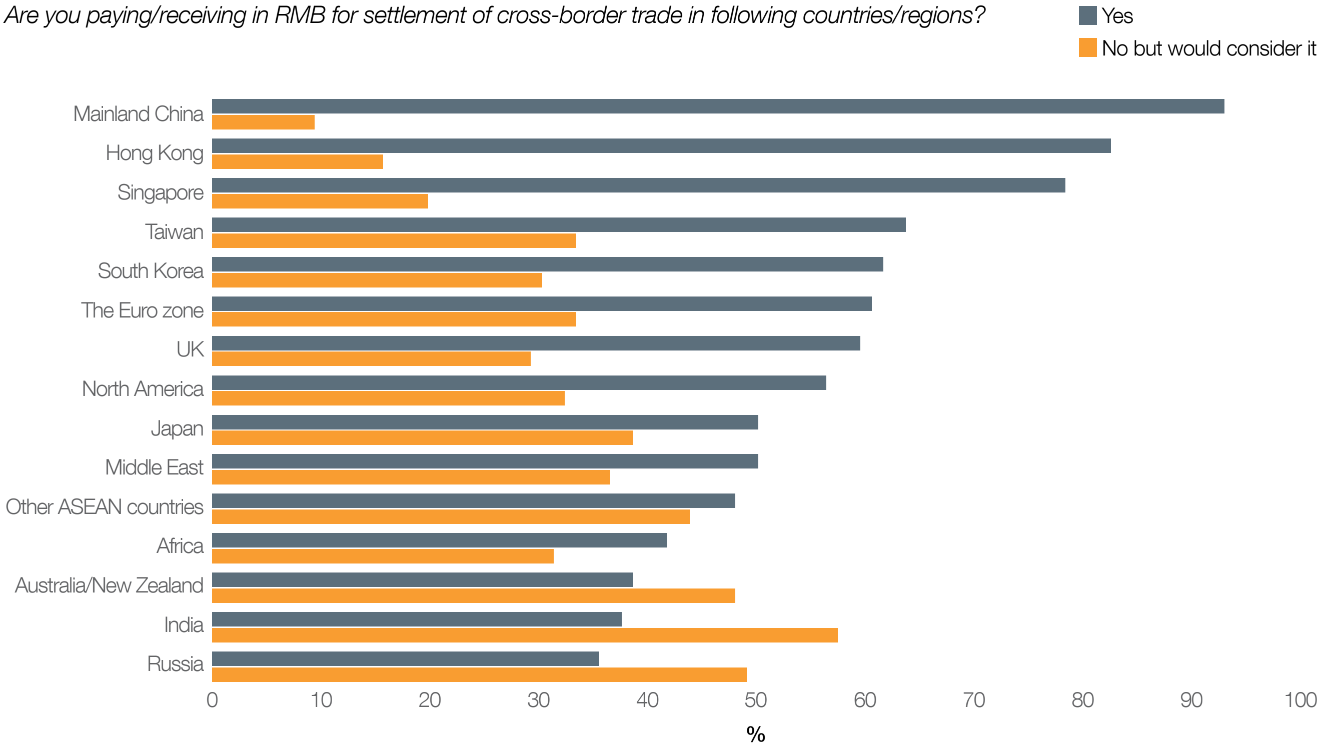
Moreover, SWIFT reported as of May 2014 that 23% of all cross-border payments in the Asia-Pacific region with Hong Kong and China were in RMB, up from 19% in May the previous year. In Europe, such payments grew to 29%, up from 19% the year before, while in Central and Latin America they rose to 66% from 59%. The use of the renminbi is an international – rather than purely Chinese – phenomenon.

"Only three years ago, companies regarded CNH as an exotic currency," says Benjamin Lamberg, managing director and head of Asian syndicates at French bank Crédit Agricole. "Today, it is seen as mainstream – and [these companies'] ability to manage it well is seen as key to their success."

Mainstream means international. The survey shows that more than 50% of non-Chinese companies use RMB for payments in multiple regions outside greater China: in Singapore, South Korea, the Euro zone, the United Kingdom and North America (Figure 1). While these areas form a kind of vanguard of international trading for CNH, others will likely follow in short order. Currently only 36% of the respondents say they are using RMB for payments in India; but 55% say they would consider it. Only 34% are using the currency for payments in Russia; 47% aren't but would consider it. A similar split of answers emerges for payments in Australia/New Zealand.

FIGURE 1: A GLOBAL PHENOMENON

Are you paying/receiving in RMB for settlement of cross-border trade in following countries/regions?

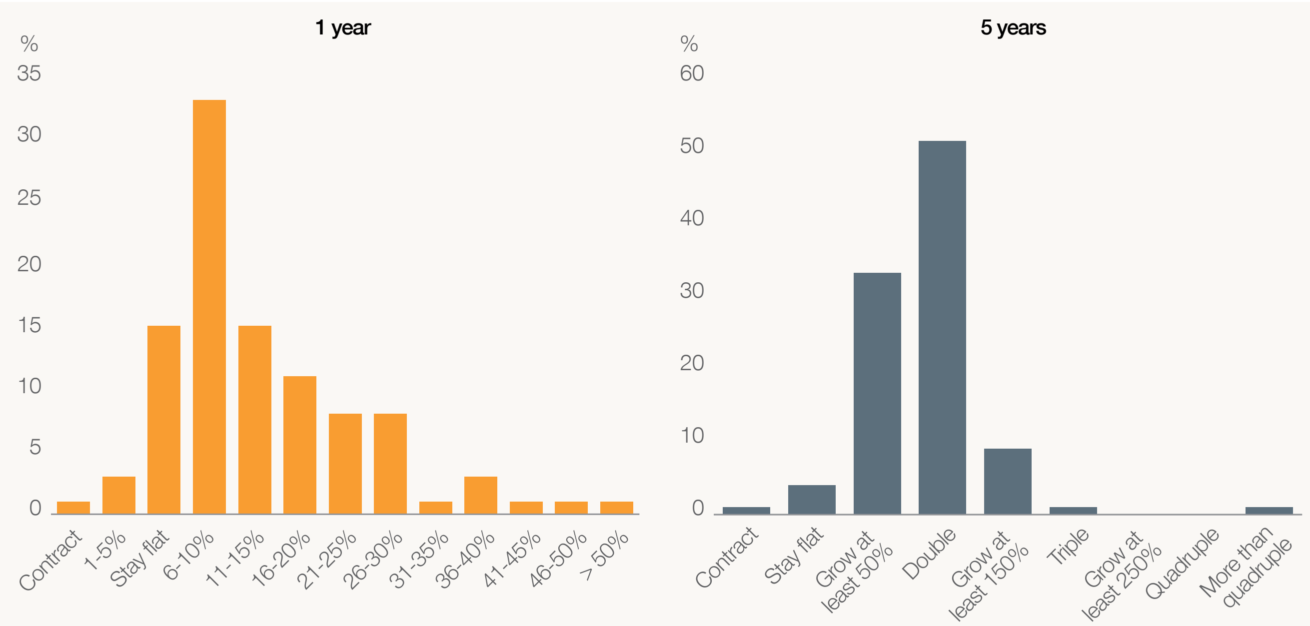


USE OF RMB ACROSS BORDERS WILL KEEP GROWING, BUT MORE SLOWLY

Almost two-thirds (62%) of companies currently using the RMB in cross-border transactions expect the volume of such transactions to double or more in the next five years. Some 11% expect it to rise by 150% or more (Figure 2). Yet in the short term the majority of non-Chinese companies currently using RMB offshore expect relatively modest growth in the volume of such transactions: 49% expect growth of more than 10% over the next 12 months while 48% expect growth of 10% or less (4% foresee no growth or a contraction). This suggests that the RMB's hitherto rapid rise up the ranks of global currencies may be set to moderate.

FIGURE 2: GROWING STEADILY

Growth in RMB transactions expected over…



SWIFT's announcement in January that the RMB had broken into the top five currencies globally by payments value, making it a "business as usual" currency, would seem to contradict this result. However, the fact that the survey excludes China-headquarted companies and focuses on corporates rather than financial services businesses explains some of the discrepancy. The expected appreciation of the RMB (driving up the value of transactions relative to other currencies, if not necessarily the volume) may also explain some of it.

In fact, usage of RMB is far from "business as usual" for many firms. Perhaps from the point of view of financial services companies, facility in using the currency has become commonplace, but many non-Chinese companies struggling to build RMB competence see obstacles to doing so, ranging from lack of knowledge internally to the delayed roll out of the China International Payments System (CIPS) to overall liquidity issues offshore (discussed in more detail in Part 4, below). Companies might well be looking at the immediate future as a period of adjustment, which would necessarily temper the pace.

MULTINATIONALS ARE USING RMB FOR MUCH MORE THAN JUST PAYMENTS

Growth in cross-border usage of RMB is not just confined to transactions or transfers, but is also seen in a host of other uses that are becoming more important to companies as their CNH exposures grow. About half (47%) of the survey respondents say they used RMB to finance acquisitions in the previous 12 months, up from 18% that did so more than 12 months ago (Figure 3). Twenty-eight percent of respondents say they have so far not used RMB for acquisitions but would consider doing so over the next 12 months. The response is all the more notable because 2014 was a slack year for China inbound foreign direct investment, up only 1.7% year-on-year, the weakest rate of growth since 2012[5].

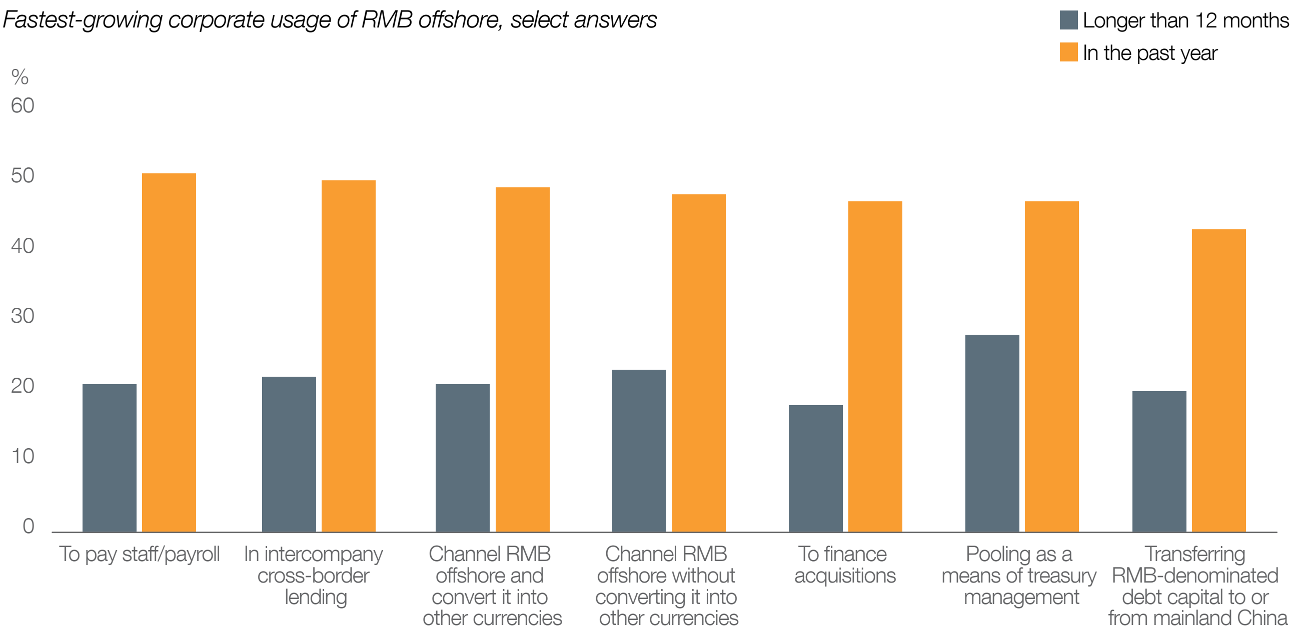
About half (48%) of the respondents say they have channeled RMB denominated capital in China offshore without converting it into other currencies over the past 12 months. This figure is twice that of the 23% that responded saying they have been doing so for longer than 12 months. This result is a natural outgrowth of easing restrictions on cross-border pooling since 2013.

The People's Bank of China (PBOC, the central bank) only allowed cross-border pooling in the Shanghai Free-Trade Zone (FTZ) from November 2013. Rules allowing the practice outside Shanghai were published in November 2014. Likewise, an easing of rules covering inter-company cross-border loans may be the reason behind the high percentage of respondents (50%) that have made these loans over the last 12 months, compared to the 22% that have been doing so for longer than 12 months.

More companies are also using RMB for cross-border transactions to pay employees, whether via payments of CNH transferred to China through a cross-border pool, or CNY transferred from within operations in China to pay employees in units overseas. The cost saving advantages of using excess RMB rather than foreign exchange is obvious. Here, too, the easing of pooling restrictions is a factor. Fifty-one percent of survey respondents say that they have paid employees this way over the last 12 months, compared to 21% who have done so for more than 12 months.

FIGURE 3: NOT JUST SETTLING BILLS

Fastest-growing corporate usage of RMB offshore, select answers



5 Reuters, "China January FDI grows strongest in four years", 15 February 2015

A&O view: Coming to China – and carrying renminbi

The rapid growth in M&A activity in China has played a significant role in the renminbi's emergence as a global currency. For multinationals pursuing investments and M&A opportunities in China, U.S. dollar or other foreign currency denominated investments are still the norm, but we have seen increased use of the renminbi in both foreign direct investment and M&A transactions. This is often a result of multinationals having a lot of renminbi on hand due to trading activity with Chinese customers or existing operations in China. Multinationals are also increasingly active issuers in the renminbi-denominated debt instrument market.

Those multinationals who bring renminbi-denominated funding to a China-based acquisition or investment gain several advantages. One clear benefit is the avoidance of foreign exchange rate fluctuations, which can make renminbi investments more attractive from a pricing point of view. On the regulatory side, funding in renminbi frequently results in smoother transactions. Chinese banks and processing agents are naturally more familiar and hence more relaxed with their own currency, meaning funds tend to be released more quickly and the associated paperwork processed more efficiently after regulatory approval for an acquisition is secured – even if the funding is raised in the offshore market.

Domestic acquisitions in foreign currency are typically subject to more limitations and hence scrutiny at the bank level.

Most important is the fact that new liberalisation initiatives and regulations are almost entirely focused on the renminbi. On a psychological level, regulators are much more comfortable lifting restrictions on the renminbi than those on foreign currencies. Companies raising funds and completing M&A transactions in renminbi now are therefore positioning themselves at the forefront of the regulatory curve and will be well positioned to benefit from future progress in the currency's internationalisation. Despite a possible slowdown in China's economic growth, the sheer size of the market and its emerging consumer class mean interest in M&A and other investment opportunities in the country will remain high. We expect more multinationals to examine renminbi-denominated funding or tap existing renminbi sources as they pursue these opportunities, smoothing the currency's path to global acceptance.

Ji Zou, Partner

Pierre-Olivier Mahieu, Partner

> "Like a pop ballad that becomes a hit, RMB may not be on everyone's playlist, but it soon will be."

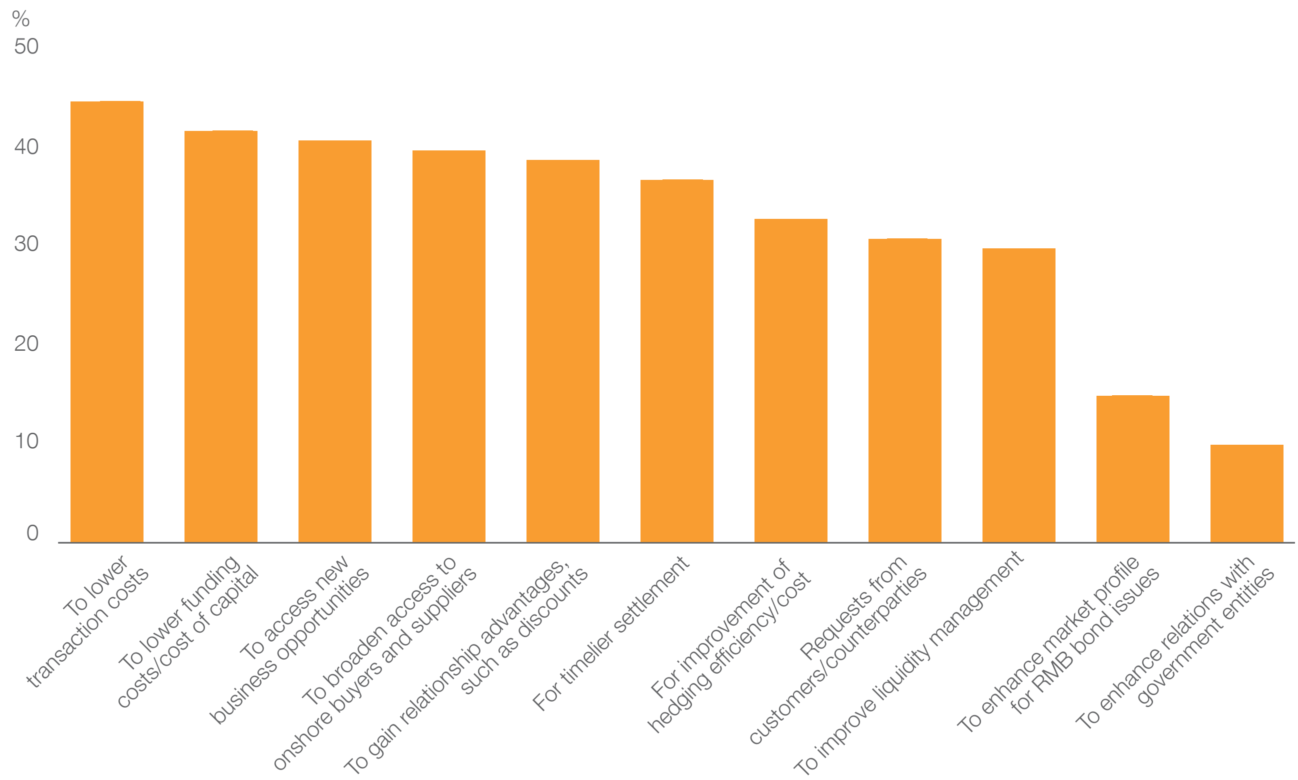
Part 2: Why paying in RMB is paying off

RMB USAGE IS DRIVEN BY COST SAVINGS – AND BUSINESS OPPORTUNITIES

With higher international usage of the currency, better management of companies' exposure to RMB becomes essential to the everyday business of dealing with customers and managing costs. Indeed, switching to RMB for payments in cross-border transactions may bring a raft of benefits: respondents say they have done so to gain lower transaction and funding costs (cited by 45% and 42% respectively in their top five reasons); access new business opportunities (41%); broaden access to onshore buyers and suppliers (40%); and gain relationship advantages, such as receiving discounts (37%). And in some cases they have followed their customers, saying that cross-border use was in response to requests from counterparties or clients (31%; Figure 4). Far fewer seem bothered about currying favour with Chinese authorities by doing so – just 10% put this in their top five, while just 15% use RMB offshore to raise their profile for RMB bond issuance.

FIGURE 4: RMB RATIONALES

Why has your company decided to use RMB in cross-border transactions? (% respondents selecting reason in top five)

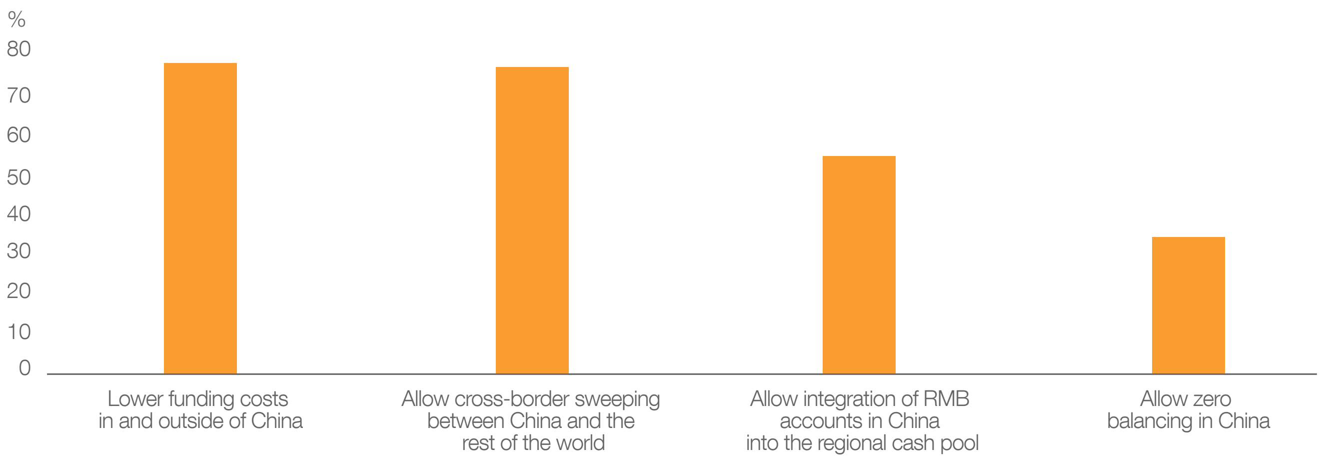


REGULATORY CHANGES ON POOLING ARE LOWERING COSTS

A signal attraction of the growing use of RMB for cross-border transactions is the ability to lower costs, an outgrowth of easier access to cross-border pooling. About a third (35%) of the respondents say they are conducting cross-border pooling in the Shanghai FTZ, while 53% say they have not set up a pooling structure there but are considering it. Of those that are currently pooling in the Shanghai FTZ or are considering it, 77% say that the practice has led or would lead to lowered funding costs in and outside China (Figure 5). The savings come from the advantage of having a freer flow of excess RMB to devote to both onshore and offshore projects, via placing cash into treasury systems at the regional level. This provides greater transparency on RMB cash flows and allows excess RMB to be swept into multicurrency notional accounts at the global or regional level for worldwide working capital purposes.

FIGURE 5: REAPING RMB REWARDS

Perceived impact of regulatory changes permitting RMB and China FX cash pooling (% respondents)



About half (54%) of the respondents also say that cross-border pooling would allow integration of RMB accounts in China into the regional cash pool. This vital link in the chain would allow companies to embrace automated cross-border sweeping quickly.

Meanwhile three-quarters (76%) say that the eased restrictions would allow them to introduce cross-border sweeping between China and the rest of the world. Pentair, a Swiss-based industrial machinery company, established a cross-border automated sweeping facility between the Shanghai FTZ and London in October 2014, a first[6].

More recently, in December 2014, UK-based engineering consultant Arup set up a similar sweeping facility between Shanghai and London (but from outside of the Shanghai FTZ), taking advantage of new rules allowing nationwide pooling[7].

Companies across China are watching. "With a pooling arrangement, we can have a much easier cash flow from our main factories in Suzhou to Hong Kong and [we] no longer [need to] make a loan application each time," says Ernest Mui, director of treasury and tax (Asia-Pacific) at German equipment manufacturer Knorr Bremse.

6 Press release, "Citi launches cross-border sweeping from China to London," 15 October 2014
7 Corporate Treasurer, "Arup Group engineers auto RMB sweep outside the Shanghai FTZ", 5 January 2015

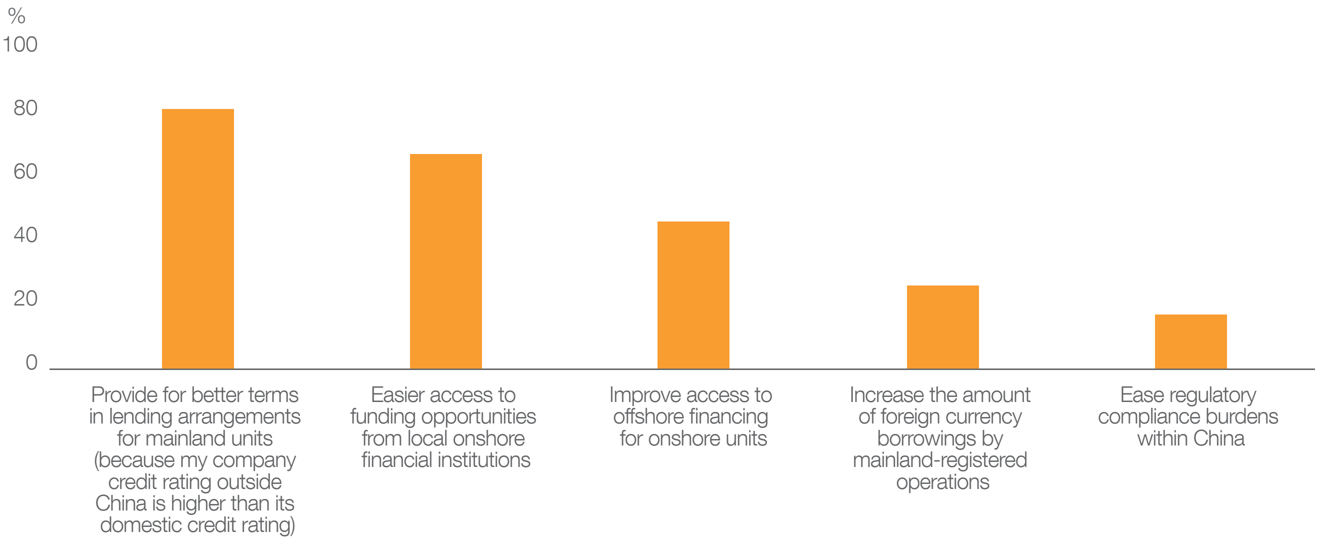
EASING CAPITAL-ACCOUNT RULES ARE MAKING ONSHORE FUNDING CHEAPER

On June 1st 2014 China's State Administration of Foreign Exchange, or SAFE, issued an edict and operational guidelines on the Regulation on Foreign Exchange Administration of Cross-border Security. The new rules in effect relax most of the existing restrictions on cross-border security guarantees. The advantage for foreign companies with China subsidiaries is that those units can now borrow locally using the credit rating of their offshore units, which in virtually all cases is higher.

More than two thirds (67%) of the respondents name easier access to funding opportunities from local onshore banks as an outcome of the introduction of new cross-border guarantee rules by SAFE (Figure 6). Eighty-one percent say that better terms in lending arrangements for mainland units (because of the credit rating advantage) are an impact of the new rules. Forty-six percent say that the new rules have improved access to offshore financing for onshore units.

FIGURE 6: GUARANTEED WIN

Perceived impact of new SAFE cross-border guarantee rules (% respondents)



A&O view: Renminbi funding comes of age

The steady internationalisation of the renminbi means more corporates are not only using it as a settlement currency, but also adding it to the list of options when they look to diversify their funding sources. Renminbi-denominated funding can be an especially compelling option for companies who conduct a significant percentage of their transactions in or have income linked to the Chinese currency, as well as those looking to manage their renminbi exposure. Many firms have already made forays into the renminbi bond market, which witnessed a flurry of issuances in recent years when many investors held broad expectations for renminbi appreciation. A less used avenue is the loan market, which has developed relatively slowly compared to the bond market due to the absence of a benchmark rate. This issue has been partially resolved with the launch of a renminbi HIBOR rate in the Hong Kong market, which should encourage companies to look at syndicated loans denominated in renminbi as a new funding option to explore. We expect the more active banks in this area will be those boasting a large renminbi deposit base, with less need to turn to expensive and sometimes volatile interbank borrowing.

While the renminbi bond market will continue to expand, there is also scope for further development in the loan and derivatives markets. Renminbi funding has to some extent been limited to larger companies who see it as a ‘must have’ to fund expansion in China, or as a diversification opportunity in a favourable pricing environment. The extension of its growth to the next tier of corporates will depend on the pricing environment being positive, as well as the availability of swap lines and ample liquidity. The possible reversal of the liberalisation trend over the last few years is a key concern, and perhaps a reason why many companies are holding back and waiting to see how the renminbi funding landscape develops. That said, the continued emergence of new offshore hubs is helping to negate the perception that there is a relatively limited amount of renminbi liquidity available, and we have seen no indications from regulators of a possible change in policy direction. The palette of renminbi funding options available will continue to diversify and deepen as the currency approaches maturity, providing new arbitrage and investment opportunities for companies in the process.

Matthew Hartley, Partner

Cindy Lo, Partner

"Leaving China
no longer means
leaving behind the RMB."

Part 3:
Strategic shifts

FREER RMB DRAWING MORE INVESTMENT TO, AND EXPANSION WITHIN, CHINA

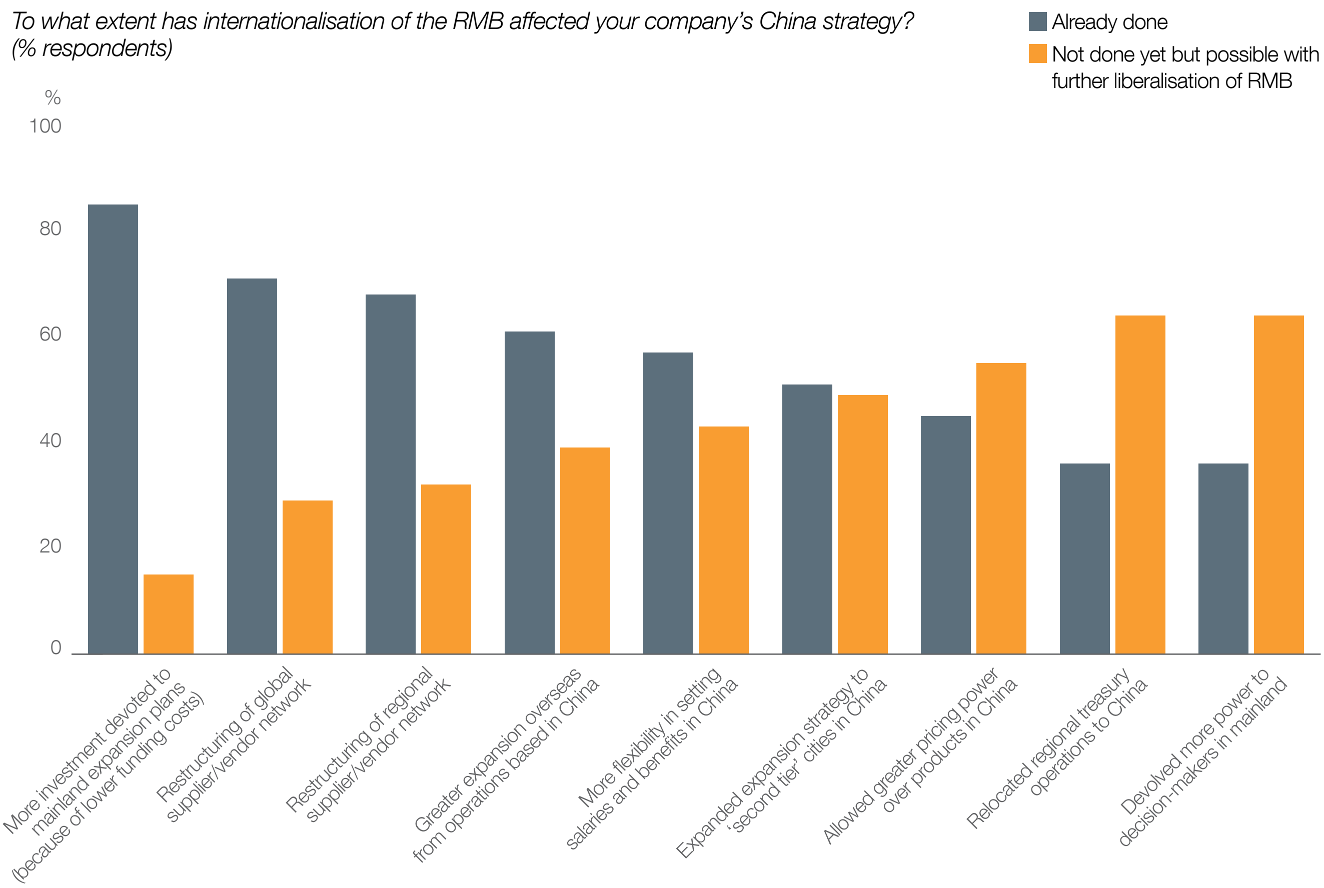
The growth of the CNH market and the pace of liberalisation are having a profound effect on companies' China strategies. Perhaps the extent of this finding has gone somewhat unnoticed because of the day-to-day nature of the advantages that a more open RMB account provides to overseas companies. Put simply, the more businesses are able to use their excess RMB like any major non-controlled currency – i.e. the "currency G4" of the U.S. dollar, the euro, British pound sterling and the Japanese yen – the more they can conduct their business related to China normally, which is to say on a more level playing field.

One primary advantage, but only the most obvious, is the ability to use CNH to fund growth plans within China. Some 85% of the respondents say that they have already devoted more investment to mainland expansion plans because of lower funding costs associated with greater freedom in their use of RMB (Figure 7). Protecting margins grows more important as China's economy slows and labour costs rise. Companies that are recasting their China strategies to vie in "second tier" cities or by introducing mid- or low-cost products against local competitors can put cost-of-funding advantages to good use.

Respondents to the survey are clear on the advantage, with 51% saying greater internationalisation or convertibility of the currency has allowed them to expand their growth strategies in the second tier, and 49% saying they have not done so yet, but expansion will be possible with further liberalisation.

FIGURE 7: CHANGING STRATEGY

To what extent has internationalisation of the RMB affected your company's China strategy? (% respondents)



RMB LIBERALISATION MAKING COMPANIES MORE COMPETITIVE IN CHINA

Premium and mid-tier market players alike see an advantage to their businesses in China of freer use of its currency. Fifty-seven percent say that internationalisation of the currency has allowed more flexibility in setting salaries and benefits in China; 45% say that it has allowed greater pricing power over products there; and one-third (36%) say that liberalisation has allowed devolution of more power to decision-makers on the mainland, a process that allows for a more nimble response to fast-paced changes in the market.

Responses indicate companies that have not yet changed their China strategy in this way see it as an important option, with 43% saying greater flexibility over setting salaries and benefits, 55% saying that better pricing power, and 64% saying that allowing more power to local business leaders is possible with further liberalisation of the currency.

RMB LIBERALISATION DRIVING COMPANIES TO SHIFT SUPPLIER/VENDOR NETWORKS

The gradual opening of China's capital account has come at a time when companies are responding to higher costs in the country by reconfiguring their supply chains, with China as a base. More than two-thirds of the respondents say that RMB internationalisation has led to restructuring of their global (71%) or regional (68%) supplier/vendor networks. The high figure reflects the prominence of this change in China strategy, an ongoing process in various sectors from electronics – with the switch of some production from China by Apple's handset supplier Foxconn starting in 2013 – to toy companies such as Hasbro that are currently mulling additional locations for manufacturing in Asia and North America, and to chemical companies that have "reshored" due to lower energy costs.

This study is the first that links greater ease of use of RMB in cross-border transactions as one catalyst to this trend. Leaving China no longer means leaving behind the RMB. In electronics and consumer goods manufacturing, common practice when supply chains shift is for the China supplier to become part of the move to another manufacturing locale. Greater ability to deploy RMB as a payment currency is attractive to both supplier and brand owner in paying for services and salaries. It allows companies that have extended their supply chains from China to tap offshore RMB to pay vendors still in China. And, as explained earlier (Figure 4) usage of RMB lowers transaction and funding costs, offers new business opportunities and broadens access to buyers and suppliers in China, among other benefits.

FREER RMB BOOSTING GLOBALISATION FROM CHINA OUTWARDS

About two-thirds of the respondents (61%) say that greater RMB internationalisation and convertibility are increasing the ability of their China-based operations to expand overseas. This is an outgrowth of several trends emerging at once. The reshaping of supplier and vendor networks described above is one, reflecting China's ongoing importance as the hub of ever more complex regional and global supply chains.

Another important driver is that multinationals' China-based customers are expanding overseas. Cross-border expansion by state-owned steel, construction, railway, nuclear power and equipment companies under a government-supported "going out" policy has accelerated in recent years. Overseas expansion is picking up in the non-state sector, too, owing to the ambitions of tech companies like Huawei and Alibaba – the latter fortified by its spectacular USD25bn initial public offering on the New York Stock Exchange last year – and services companies like CTrip, China's biggest travel website, which is tapping into the growth of Chinese overseas tourism. Internationalisation of the RMB is supporting the ability of non-Chinese companies to follow their mainland customers.

The trend is set to continue. More than a third (39%) of respondents say that freer use of the currency has not yet allowed them to engage in greater expansion from China, but with further liberalisation it is possible

MIGRATION OF REGIONAL TREASURY CENTRES TO CHINA IS LIKELY FOR MANY

One-third (36%) of respondents have already relocated regional treasury centres to China, while some 64% say such a move is possible with further currency liberalisation. Those that have moved would necessarily have situated their operations in the Shanghai FTZ, as rules governing such treasury matters as cross-border pooling outside of the Shanghai FTZ have only recently been eased. These new rules allowing nationwide pooling will prompt companies to consider moving at least some aspects of regional treasury to elsewhere in the country. In December 2014, Citibank announced that it had partnered with an undisclosed "leading consumer goods company" to launch a cross-border pooling venture outside of the Shanghai FTZ[8].

Nonetheless, companies thinking of adopting more sophisticated treasury operations outside of Shanghai still face obstacles. "The truth is that all the services, the pilots and the banks are already in Shanghai," says Michael Chang, senior director, global services China for Danish equipment manufacturer Danfoss. "It would be difficult to duplicate this cluster elsewhere in China."

This may change. In January 2014 China's central government agreed in principle to approve 12 new free trade zones, including one in Guangdong and one in Tianjin[9].

8 "Citi launches RMB cross-border pooling venture", Asian Banking and Finance, 10 December 2014
9 "12 new free-trade zones to follow in Shanghai's footsteps", South China Morning Post, 23 January 2014

SINGAPORE WILL MATCH SHANGHAI FOR OFFSHORE RMB TREASURY MANAGEMENT

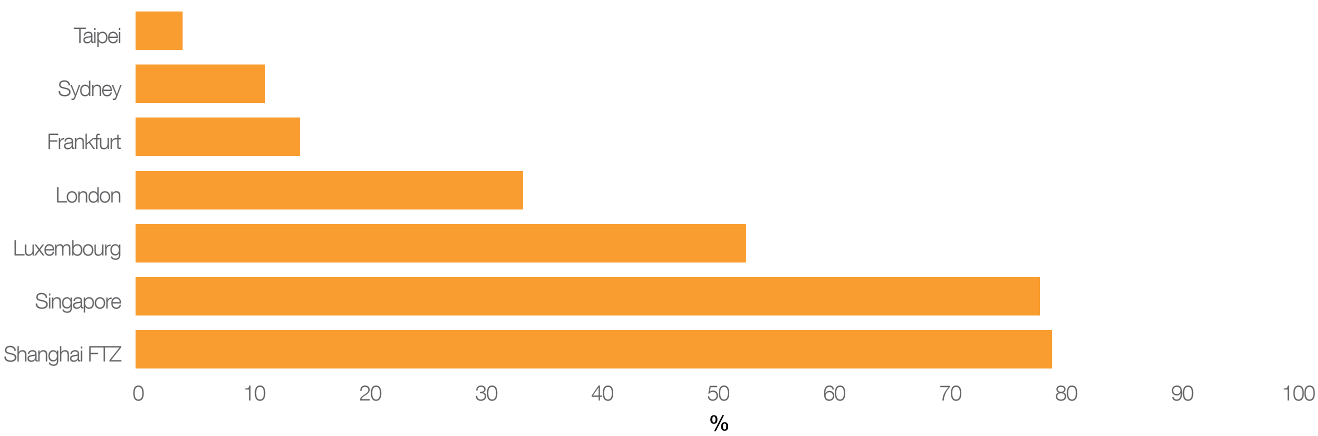
Some 78% of respondents name Shanghai's FTZ as likely to be in the top-three most attractive offshore centres for managing RMB liquidity (outside of Hong Kong) over the next five years, while 77% pick Singapore. More than half name Luxembourg (52%) in the top three, while only a third (33%) pick London (Figure 8).

The response for Singapore, which only became a centre for offshore RMB trading in 2013, should only be seen as a measured triumph. Singapore overtook London as an offshore trading centre of RMB in February 2014 and has retained its dominance since. But most offshore RMB trading is still in trade finance, of which Singapore is already the Asian hub[10]. More than two-thirds of all global foreign exchange trading, however, takes place in London, suggesting that as companies embrace more sophisticated RMB trading strategies London will make up for lost time.

Regarding Shanghai, the response is less reassuring. Companies prefer the Shanghai FTZ for some treasury operations over other locations in China, but this does not suggest that Shanghai FTZ is fully ready to compete against Hong Kong or Singapore as a thriving offshore trading centre. The experiment is still young, and companies are still assessing its benefits.

FIGURE 8: WINNING THE RMB RACE

Which offshore centres outside Hong Kong are likely to be the most attractive for RMB liquidity management for all companies over the next five years? (% respondents selecting in top three)



10 "Singapore overtakes London in RMB trading", Financial Times, 26 April 2014

A&O view: Hub(ble) bubble – Middle East and Africa's pitch for RMB business

Trade volumes – generating intense demand to transact in renminbi and to hedge renminbi exposures – are the basic driving force behind the opening of new renminbi hubs. That said, expected liberalisation of renminbi in the coming years is also a likely catalyst. It's certainly possible that new renminbi hubs are likely to arise in the Middle East. Certainly, China's demand for Middle East oil has made renminbi exposures more relevant to that region. At the same time, we must remember that financial centres in the Middle East such as Dubai and Abu Dhabi have been growing at an enormous pace during the last 15 years, and new ones such as Casablanca are emerging. In addition to the clear nexus to renminbi transactions in the region, these financial centres rightly see renminbi as a significant currency behind the dollar, euro and others that will only grow in importance in the coming decades. These centres don't want to be left out of the global renminbi trade and the plethora of renminbi-denominated financial products likely to arise from it.

Heath Tarbert, Partner

Part 4: The obstacle course

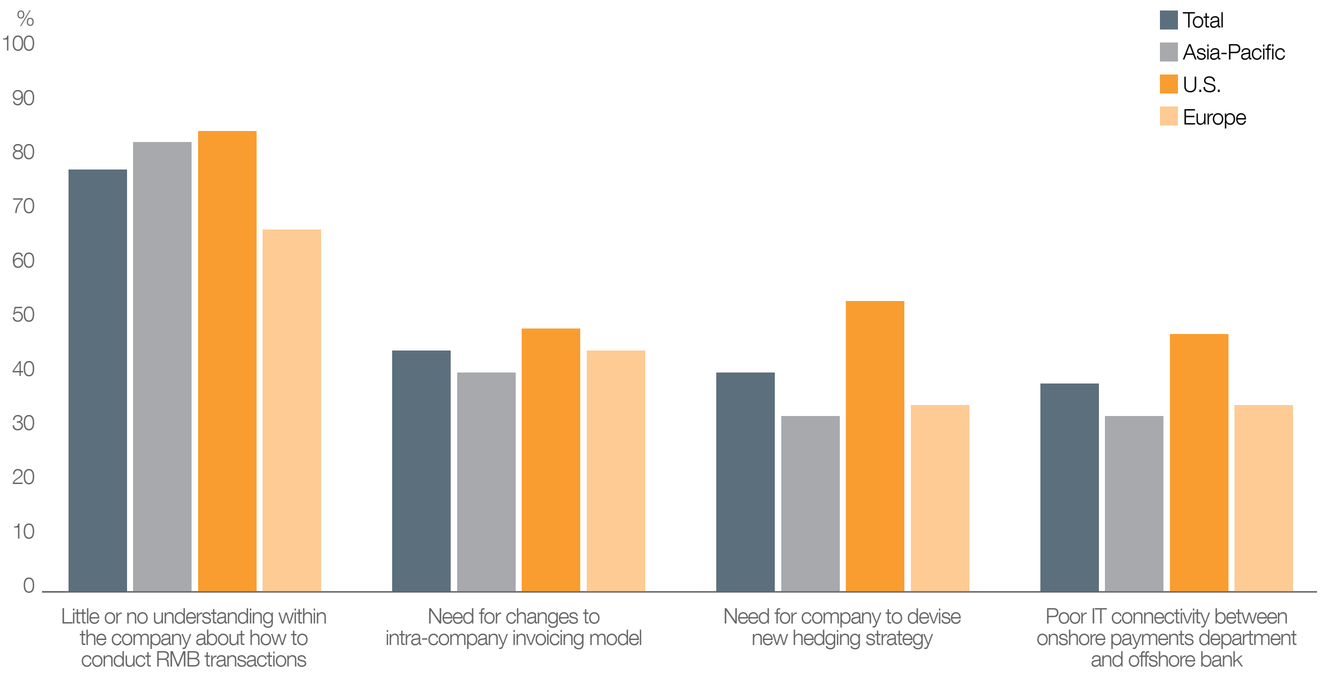
MOST COMPANIES ARE STILL WORRIED ABOUT INTERNAL COMPETENCE WITH RMB TRANSACTIONS

It is hardly a surprise that suddenly greater volumes of transactions in a currency that leapt into fifth place in terms of global payments from 20th position as recently as December 2011 would present problems for many companies. The question to ask is not whether the RMB is ready for the world, but whether the world is ready for the RMB.

The biggest obstacle to greater usage of the RMB by businesses internationally lies in the slender grasp non-Chinese companies have on how to conduct RMB transactions. This varies by region: it is cited as a very important or important obstacle by 84% of U.S. respondents and 82% in the Asia-Pacific region, but just 66% of European respondents (Figure 9), reflecting a possible edge in Europe in building RMB competence.

FIGURE 9: NOT THERE, YET

Greatest company-specific obstacles to usage of RMB in cross-border transactions (% respondents rating issue as "very important" or "important")



That European edge has come from necessity, according to Crédit Agricole's Mr Lamberg: "Part of that better competence has been because of low growth in the euro zone, forcing European companies and banks to rely on stronger currencies to stablise their cross-border businesses. It makes sense that the currency of choice would be CNH, because of European companies' long established presence in Chinese markets."

Nonetheless, Europe's relative competence can hardly be called a triumph if two-thirds of its companies are still struggling. An inadequate grasp of procedures and controls necessary for the smooth management of RMB payments and other activities puts companies at a competitive disadvantage to globalising Chinese firms. In itself, a lack of understanding is an impediment to operational fixes that would ease cross-border usage. More than a third of the respondents (44%) see a need to change intra-company invoicing models as an important or very important obstacle to using the RMB more in cross-border transactions, while 38% name poor IT connectivity.

LACK OF HEDGING OPTIONS ALSO PUTTING MANY OFF

Some 40% of respondents cite the need for a new RMB hedging strategy as an obstacle to greater usage of the currency, suggesting that banks have a key role to play in helping companies build competency in managing cross-border RMB flows.

Company treasurers sometimes complain about the lack of RMB denominated hedging products in the market: insufficient liquidity in offshore RMB hedging instruments, such as RMB forwards, forex options, and swap, was cited by 36% as a very important or important obstacle to the greater usage of the currency.

However, many are unaware of how quickly hedging tools are developing in CNH centres such as Hong Kong and Singapore. Bank of International Settlements (BIS) data show RMB trading in four categories, as of August 2014: spot (USD34bn), outright forwards (USD28bn), FX swaps (USD40bn) and options (USD17bn)[11]. Significantly, two-thirds of this total trading universe takes place offshore in CNH (the ability to trade derivative products is still limited in China).

The decline in the RMB's value against the dollar starting in January 2014 intensified treasurers' focus on hedging the currency. Some bankers, including Mr Lamberg, believe that increased volatility in the currency is one reason that RMB trading volumes have risen so dramatically over the past year, as two-way movement in the currency intensified.

Onshore, the government is gradually loosening the ability to hedge in CNY using basic options strategies. Lee Beng Hong, head of markets in China for Deutsche Bank, says that bankers have to take an active role in educating local companies, explaining the benefits of hedging with options not only to treasurers, but also their bosses in the C-suite. "We have to make sure we educate the client across the whole ranks," says Mr Lee.

11 As cited in Corporate Treasurer, "RMB hedging best practice", 4 August 2014

LACK OF OVERALL RMB LIQUIDITY IS STILL AN IMPORTANT OBSTACLE

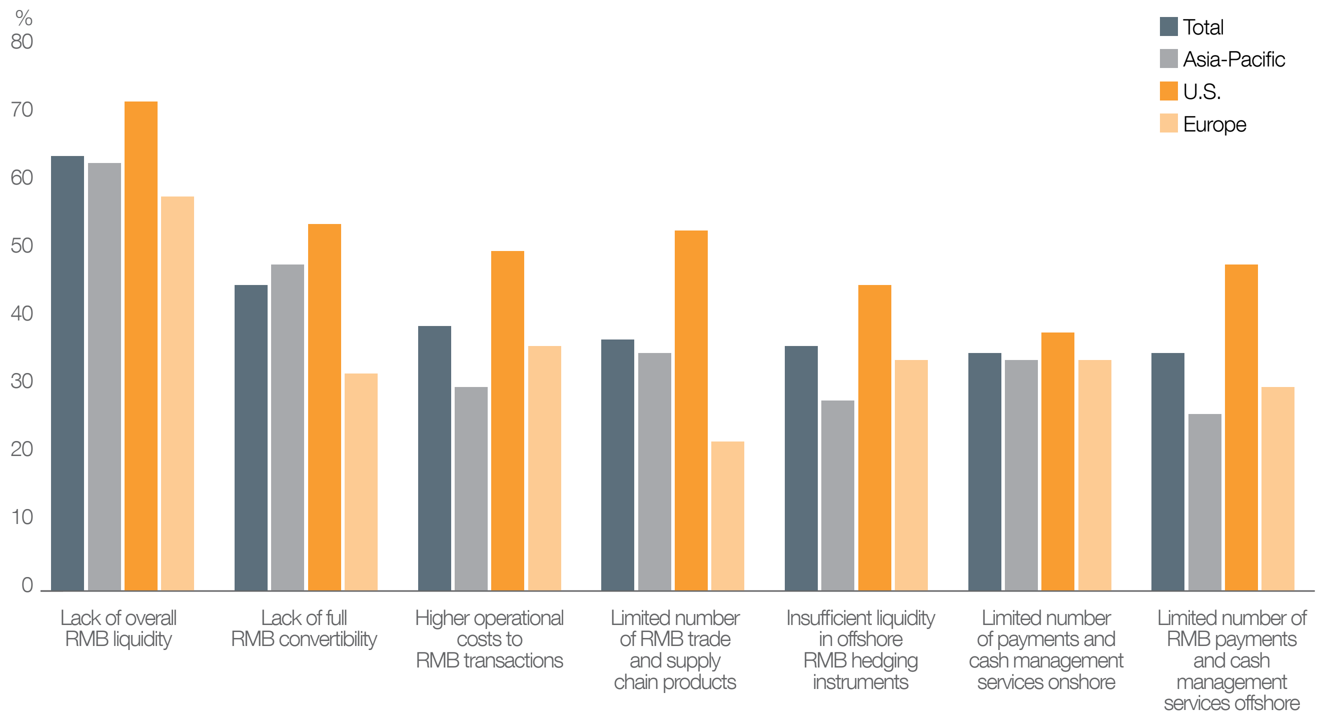
Two-thirds of respondents (64%) say a lack of overall liquidity is an important or very important obstacle to greater usage of the RMB in cross-border transactions (Figure 10). This is perhaps unsurprising given that even in the top five payments currencies globally, the RMB has an awful long way to catch up with the "G4" currencies in terms of the daily trading volume and variety of instruments available.

While lack of liquidity is a concern, that there are still controls on the movement of the currency across China's borders is not as great a problem as might be expected.

A lack of full convertibility of the RMB is seen as an impediment by less than half (44%) of the respondents. If the figure seems low, it is important to remember that the respondents to this survey are not financial services companies that rely on high volumes of trades, but non-financial companies such as manufacturers and service providers that are still grappling with the day-to-day operational issues of managing their exposures. In a real sense, these companies are struggling to keep up with the reforms already introduced by China to liberalise the currency. In this respect, it's understandable that full convertibility is not at the very top of the wish list.

FIGURE 10: LIQUIDITY PREFERENCE

Greatest liquidity/operational obstacles to usage of RMB in cross-border transactions (% respondents rating issue as "very important" or "important")



DELAYS IN DEVELOPMENT OF INTERNATIONAL RMB CLEARING PLATFORM A STICKING POINT

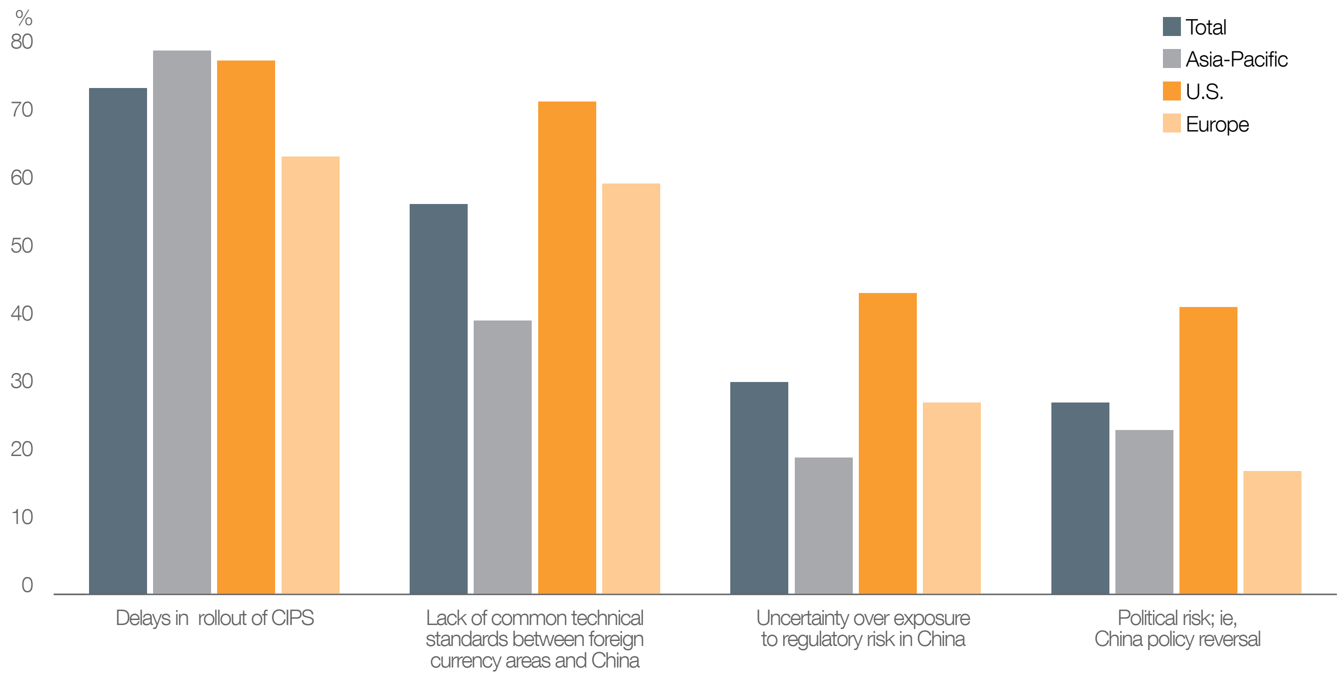
Delays in the rollout of the China International Payments System (CIPS) are cited by a significant majority (74%) as an important or very important obstacle to their use of the RMB in cross-border transactions (Figure 11). The operational start of CIPS, intended to put the RMB on an even footing with the U.S. dollar and the euro in areas such as operating hours, risk and liquidity management, has missed key deadlines and was pushed back again last year until 2016. One of the issues that has dogged the rollout – the difficulty in harmonising technical standards between clearing banks in China and those outside the country – is also seen by 57% of the respondents as an important or very important obstacle to their cross-border use of RMB.

The delays to CIPS have also been seen as a corollary to frustrations over management of RMB exposures generally that emerged amid the higher volatility in the currency in 2014. The long wait for CIPS has built expectations that the platform will erase some current challenges in managing wonky technical issues that arise in settling cross-border transactions.

To take one example of one of those challenges: SWIFT commonly uses Latin characters, but to message banks in China the network must resort to using local Chinese commercial code. Translating between the two requires manual input, a method both frustratingly slow and open to error.

FIGURE 11: REGULATORY ROADBLOCKS

Greatest regulatory obstacles to usage of RMB in cross-border transactions (% respondents rating issue as "very important" or "important")



POLITICAL AND REGULATORY DISRUPTION LESS OF AN OBSTACLE THAN EXPECTED

International companies that use the RMB across borders appear to be relaxed about the impact on the growth of such transactions of headline-grabbing issues that have emerged in China in recent years. Concern over exposure to regulatory risk (31%) and the prospect of policy reversal on the internationalisation of the RMB (28%) are lower than may be expected, given the intensity of media coverage of China's anti-trust drive and the nationwide anti-corruption campaign, and the serious consequences for any company that falls under investigation. The answer may lie in the open-ended nature of the twin drives, which have been gathering steam for two years and counting. Tighter regulatory scrutiny has become a day-to-day feature of China business affairs. Some disruption aside, businesses have continued trading much as before.

Moreover, although China's regulators have been moving slowly to open the capital account, the pace has been reassuringly steady. "The government doesn't want to be too risky, or to move too fast," says Yigen Pei, country head of trade and treasury solutions for Citibank, China. Yet he also says that it engages in active dialogue with multinational companies seeking to make sense of regulatory change, and they can manage the risk and harness the benefits. "China is so vast," says Mr Pei. "We have to understand exactly what the regulators think. Fortunately, they encourage back and forth discussions."

> "The question to ask is not whether the RMB is ready for the world, but whether the world is ready for the RMB."

A&O view: Hedging – the shape of things to come

Corporate treasurers are developing more diverse views towards renminbi exposure. If you look at multinational companies, especially those with operations in China or those who have trading relationships with Chinese counterparties, they increasingly use renminbi as a settlement currency. At the same time, there are also different channels available for companies to obtain renminbi funding. If they look at renminbi as a settlement currency, companies will need to look at currency exposure, and I think increasingly they are considering hedging options and whether they can tap into renminbi funding sources, whether onshore or offshore.

Cindy Lo, Partner

About the survey

The report is based on a survey of 150 senior executives conducted in January-February 2015, including 50 from each of the U.S., Europe and the Asia-Pacific region. All companies in the survey have some exposure to the renminbi, but companies headquartered in greater China (i.e. China, Hong Kong or Taiwan) were excluded to ensure the results reflect how the liberalisation of the currency is affecting corporate strategy globally. Respondents come from a range of sectors, including manufacturing (26%), consumer goods & retailing (19%), IT, technology and telecoms (16%), the automotive sector (7%) and others (Figure 12). The survey excludes companies in the financial services sector.

Some 31% of respondents work at companies with global annual revenues of USD10bn or more and 34% represent businesses with sales of between USD1bn and USD10bn (Figure 13). In terms of seniority 50% are either board members or C-suite executives, 30% are senior vice-presidents, vice-presidents or directors, and the remainder are senior executives and managers.

Survey responses may not add up to 100% either due to rounding or because respondents could pick multiple answers.

FIGURE 12: SURVEY RESPONDENTS BY INDUSTRY

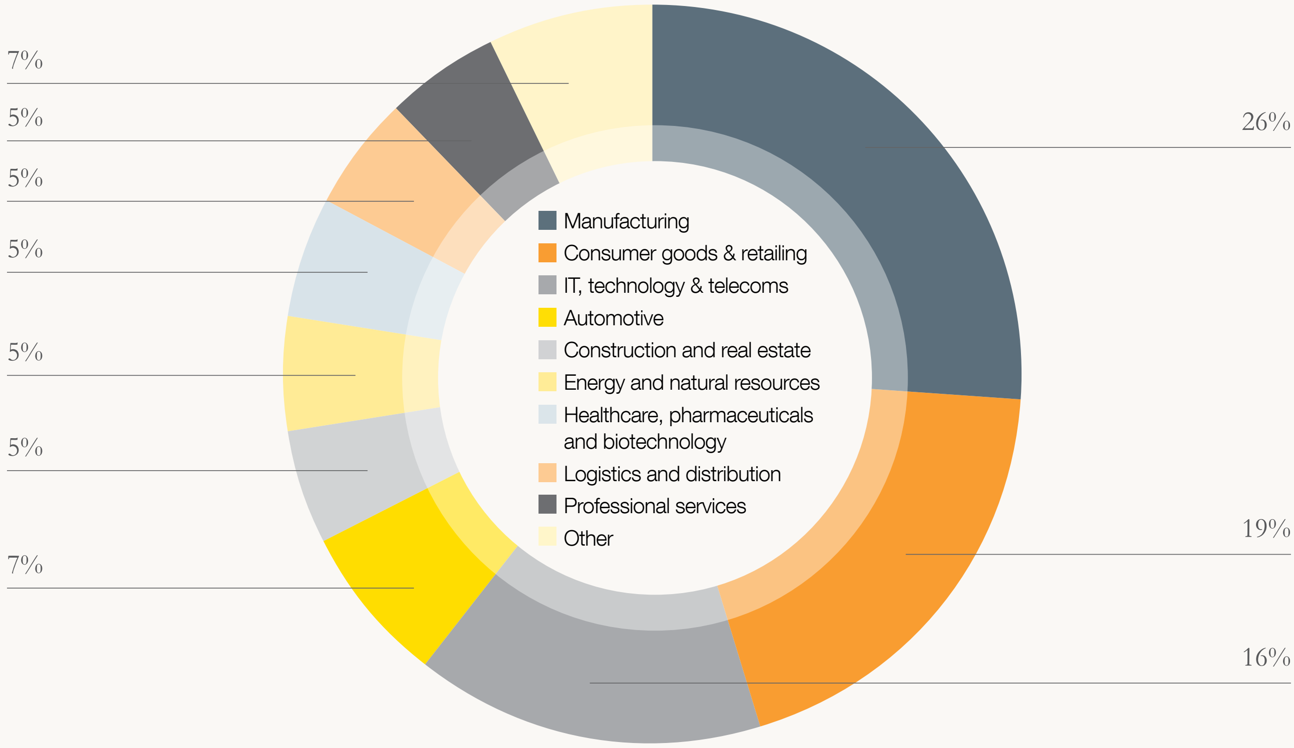
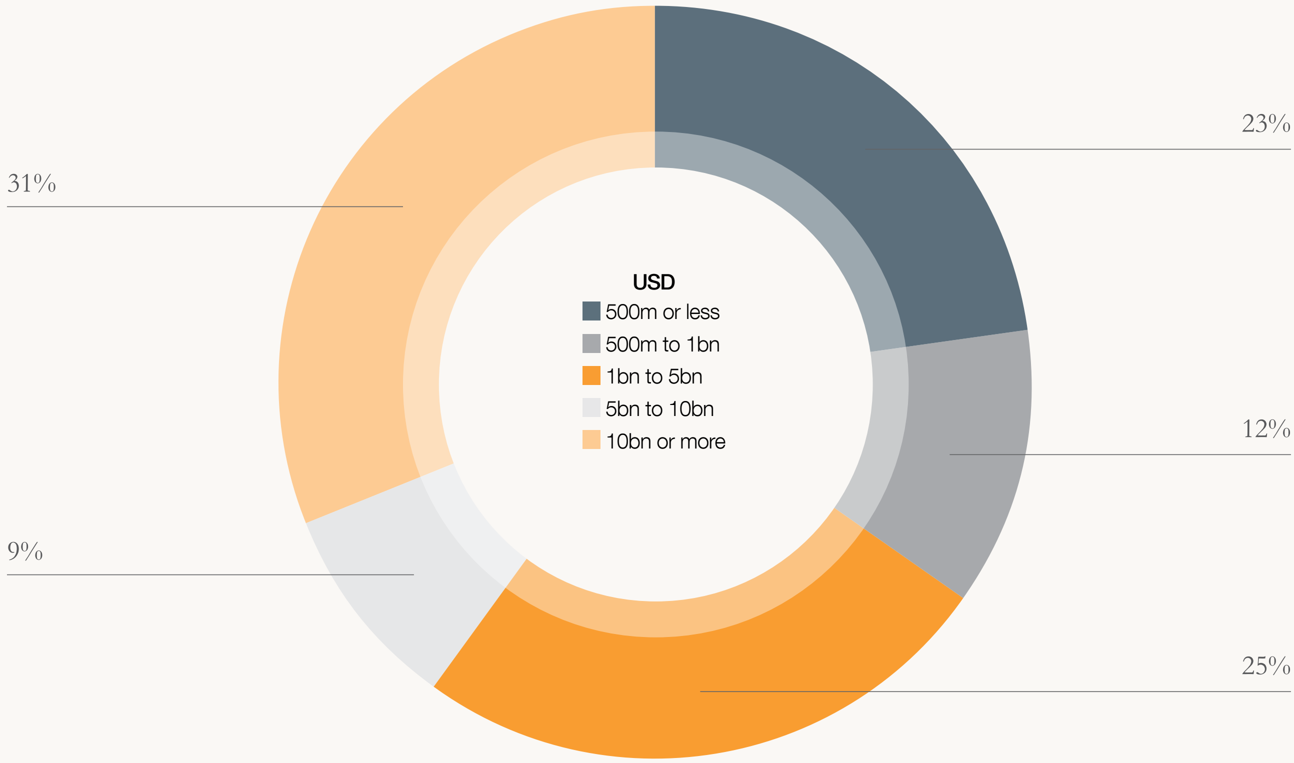


FIGURE 13: SURVEY RESPONDENTS BY COMPANY SIZE (REVENUE)



“It’s now like anyother major currency to us”

Appendix:
Case studies

Danfoss: A playbook for the Shanghai Free-Trade Zone

How treasury at Danfoss has grown in tandem with Shanghai's easing of restrictions on cross-border transactions

The extent to which rules would be relaxed for companies operating in the China Shanghai Free-Trade Zone (CSFTZ) was uncertain when China launched the experimental scheme in September 2013. But the pace of liberalisation has been brisk. "It came a whole lot faster than we expected," says Kjeld Staek, president of Danfoss China, a Danish maker of refrigeration, heating and infrastructure equipment, with USD5.1bn in annual sales and a presence in China since 1996.

In November 2013, the People's Bank of China (PBoC, the central bank) issued a 30-clause set of guidelines allowing practices in the CSFTZ such as RMB cross-border sweeping and pooling, cross-border POBO/ROBO ("payment/receivables on behalf of"), RMB cross-border payment and netting, and borrowing from the CNH (offshore) market.

The guidelines set down a framework for corporate treasurers to link their China cash pools with Asian regional treasury centres. Swiss life sciences company, Roche, became the first to establish an automated cross-border pooling structure in the CSFTZ, in January 2014, followed by French distributor Sonepar. By the middle of last year, auto, logistics and retail companies were all setting up two-way sweeping and pooling structures.

IN PURSUIT OF COST SAVINGS

Danfoss's shift to Shanghai is an outgrowth of its rapid expansion in China, which has become critical to the company as a market, production and supply centre. It employs about 4,000 workers in China, or about 15% of its global workforce. China is its third-largest market for sales, and its largest sourcing market. Rapid growth has not always been easy to manage: before the easing of restrictions on cross-border RMB flows in the CSFTZ began in 2014, the company's six factories and 13 sales offices in China (operating under 11 separate legal entities) had to buy U.S. dollars or euros to pay for goods and services to other Danfoss units outside of China – a costly practice in terms of exchange rates and employee time.

According to Michael Chang, senior director of finance and accounting for Danfoss China, the ability to pool its cash generated in China and make cross-border payments in RMB via the CSFTZ provided Danfoss with an opportunity to hedge against currency exposure and manage its costs better. It brought other benefits, too. Under the eased regulations, Danfoss saw a chance to improve working capital management for its 11 legal entities by pooling its onshore and offshore RMB and using it to provide its factories with funding via intracompany lending from an in-house bank. It has made available excess RMB funds to its domestic businesses this way.

Danfoss was well placed to pursue these goals, because, in a sense, the China Shanghai FTZ grew up around the company, which had a sales trading entity in the city as far back as 2001, and enjoyed the benefits of a precursor to the expanded Shanghai Free-Trade Zone, the FTZ in the city's Waigaoqiao district.

In 2012, Danfoss applied to and was selected by FTZ Waigaoqiao Administration Committee to be in the vanguard of 20 companies (including General Electric, Sony and Volvo) in a pilot programme that would allow them to adopt Shanghai as a regional hub for sales, logistics and capital settlement. The scheme, dubbed the Asia Pacific Operations Programme (APOP), was a part of various reform pilot programmes developed under the China Shanghai FTZ – the overseer for which is now the zone's administration committee.

PART OF THE PILOT

Under the APOP – which is still ongoing – the local government designates companies as 'champions' to engage in activities allowed by the easing of restrictions, such as cross-border pooling. The benefit for the selected companies is the chance to gain an edge in restructuring their China operations. It also offers them an ongoing dialogue with regulators – a distinct advantage in China, where understanding the boundaries of developing practices necessarily requires face time with officials.

In response to the lifting of restrictions in late 2013, Danfoss set up a joint project team between its group treasury in Denmark and its Global Services China Finance and Accounting division in Shanghai, and created a new internal finance and accounting system. The system took advantage of the new pooling structure and established a modus operandi to adjust to additional easing of restrictions as it arises. So far, the project has delivered EUR300,000 (USD340,000) in annual savings. Mr Chang anticipates greater savings in 2015.

The restructuring has also boosted the company's ability to use RMB as an internal currency. Danfoss currently transacts half of its China intercompany cross-border supply chain and trade settlements in RMB. Mr Chang says that the company will meet its goal of making all such payments in RMB by the end of this year. The new structure has allowed Danfoss to shift all RMB intercompany trade settlements previously done in various legal entity locations around Greater China to Shanghai, gaining efficiencies by consolidating these activities in one location, as well as greater visibility over all RMB transactions.

Mr Chang adds that simplified tax procedures in the CSFTZ helped Danfoss make these moves. Previously, the company had to wait about three months for approvals that would allow it to pay taxes on non-trading transactions, such as cross-border business services and dividend distribution. Now, it is possible to make the payment first, document and report it, and then pay tax.

NOT QUITE GLOBAL

Dialogue with regulators – in this case, the Administration Committee of the Shanghai FTZ – began early, when Danfoss discussed a wish list of the activities it wanted to initiate in the zone. "Under the pilot scheme, we've been giving our input; we're among the first to try stuff," Mr Chang says.

Today, it has accomplished much of that list. However, the full link to global treasury operations is yet to come. The company is currently reviewing how to remit pooled RMB sent to its global multicurrency notional cash pool account in London back to China for use by China entities for working capital purposes. Danfoss is reviewing another option offered by authorities in the China Shanghai FTZ: the establishment of a non-resident account, which would allow this.

This final link is important, because it would allow Danfoss to tap into RMB cash generated offshore for its growing China businesses. Companies can do this under non-resident accounts because the vehicles are structured to allow regulators visibility into offshore transactions that they previously did not enjoy.

Danfoss is still weighing the benefits against the risks of doing so. The benefits are obvious: as the company's available cash in offshore RMB grows it will be able to make a greater pool of RMB available to its factories for working capital, further decreasing currency exchange exposure. The risks, so far, appear to be academic – possibly in greater paperwork and more scrutiny. But Mr Chang says Danfoss is inclined to make the move anyway.

A rare breed: Daimler's panda bond

The German auto maker pioneered the first corporate panda bond issue and says this is just the beginning

Despite the size of its business in China – about 10% of its global revenue of EUR118bn (USD133.5bn) – Daimler AG has never made a secret of its ambitions to do better. Hubertus Troska, chief executive for China at the German auto-making giant, said in November 2013, "I don't see any reason why we should not be growing stronger than our competitors."

Daimler sells a host of different vehicles in China – trucks, vans, 'smart' cars, and luxury Mercedes-Benz sedans. But it realised by 2013 that it risked declining sales in the years ahead as China's economy slowed.

Total car sales for all manufacturers in China have dropped. Sales of passenger cars peaked in 2013, with 16% growth over the year before. At year-end 2014, growth fell to 6%. The China Association of Automobile Manufacturers forecasts growth of 7% in 2015. A government crackdown on carbon emissions has added to the slowdown, with limits on car purchases introduced in Beijing, Guangzhou, Shanghai and Shenzhen.

Daimler has responded with a strategy shift, intensifying its focus on selling to the luxury market. To support the strategy, it announced in mid-2013 that it would invest EUR2bn (USD2.7bn) to double its production of Mercedes Benz cars in China to 200,000 and open its first engine-building facility in the country.

Daimler typically covers most of its financing needs in local markets, via bank debt or in the bond markets. Bond yields were still relatively low in early 2014, ahead of the end of the U.S. Federal Reserve's decision to end its quantitative easing programme, and bond issuances offered the most attractive financing terms. Throughout the year, Daimler issued bonds worth EUR43.2bn (up from Euro 38.7bn in 2013) in locations as diverse as the U.S., Germany, Mexico, Brazil, Argentina, South Africa, Thailand and South Korea.

NOT OFTEN SEEN IN THE WILD

Daimler chose to raise debt via bonds in China, too, but the issue was no ordinary affair. The company opted to issue the first – and as yet, only – 'panda bond' by a non-financial company, rather than opting for a lower-cost option of raising RMB offshore in the dim sum market.

Panda bonds are RMB-denominated bonds sold in the local market by a non-Chinese issuer. The market opened in 2005 with simultaneous issues by International Finance Corp and the Asian Development Bank. Yet the panda market has seemed like a long dress rehearsal for a play that hasn't opened yet.

Only a handful of foreign banks have issued pandas. Several foreign non-bank companies made overtures, including British food retailer Unilever, which engaged in preliminary talks with the People's Bank of China (PBoC) and National Association of Financial Market Institutional Investors (NAFMII), a China self-regulating body, to issue a panda note in 2011 – but it ended up backing away.

Unilever opted to issue a RMB300m (USD46m) three-year dim sum instead, drawn to the lower yields typical of the offshore market and perhaps daunted by the prospect of lengthy negotiations with regulators characteristic of a pioneering issuance in China's capital markets.

Average yields in the offshore RMB bond market stood at 2.96% for the overall market at the beginning of 2014, and 1.24% for dim sum central government issuances. Yields were rising, as greater currency volatility emerged at the end of 2013, but offshore yields were considerably lower than in the onshore market. From mid-2013 to the beginning of 2014, top-rated onshore corporate bonds offered yields of more than 5%, while central government issuances featured yields of just under 3%.

A CAREFUL, DELIBERATE MOVER

Daimler decided to issue a panda anyway, couching its decision to pursue the issuance as strategic, with price as a secondary concern.

"We started monitoring the capital markets in China and Hong Kong – like all other relevant capital markets – very carefully a long time ago," Daimler said in an emailed response to the Economist Intelligence Unit.

"Interest rates are one important factor for entering a market. In fact, we might have reached a better interest rate in the dim sum market in Hong Kong. Though, other criteria are also important: China is one of our biggest markets, and we expect further significant sales potential for cars and trucks in the future.

"Therefore we'd like to refinance our capital needs in China in the long term and to contribute in this way to open and broaden the Chinese capital market. Our preference was long-term oriented and strategic, not short-term attractiveness.

"In the long run, we will see much bigger demand and supply in the panda bond market compared to Hong Kong. The reason is pretty simple: the Chinese economy and the disposable income looking for financial assets will be much bigger than in Hong Kong."

After talks with NAFMII and a nod from the PBoC, Daimler decided to raise RMB2bn in two separate issues, testing the waters first in March 2014 with a one-year RMB500m (USD81.5m) bond with a 5.2% yield. (The average in the Hong Kong dim sum market for a top-rated security that week was 4.8%.) A second offering worth RMB1.5bn followed in November. "We will use the proceeds form the two bond issues to finance our strong growth in China," Daimler said.

Demand for the initial Daimler panda proved to be strong, even though the issuance followed the first-ever bond default in China's domestic market, which investors shrugged off. "For Chinese investors, interesting investment options are rare, besides the traditional offering. Therefore the new investment options have been well received," Daimler said.

SLOW TO REPRODUCE

Even so, the government has been in no rush to allow foreign companies to tap into the domestic bond market. It is the third largest in the world at roughly USD5tr, after the U.S. and Japan, but corporate bonds still account for a relatively small proportion.

China's regulators have never explained why it has taken them so long to allow foreign companies to issue panda bonds. Regardless, much needs to be done to make the market fully functional before letting in a flood of foreign issuers, including the development of benchmark sovereign rates to facilitate pricing, a classic bond repo market, and clear guidance on disclosure.

The stage does seem set for follow-on pandas from other foreign corporates in 2015. The spread between the offshore and onshore markets is narrowing. Average yields onshore fell to 4.89% in January 2015, while dim sum yields have been climbing, reacting to a default by prominent dim sum real estate issuer, Kaisa, and greater volatility in the CNH market generally.

Meanwhile, Daimler's new investments in China have already helped deliver strong results. Sales of Mercedes-Benz luxury cars grew 29% in China in 2014 to 281,588 units. Mr Troska told reporters in Beijing in February that he expected the brand to sell over 300,000 cars in China in 2015. Daimler now has the option to revisit the panda market as an established borrower with attractive recognition to investors.

And it will be back. "We see continued strong interest from Chinese investors and see good opportunities to place bonds broadly in the Chinese capital market," the company said in an email. "Further issues are therefore likely to follow."

Milk runs

Mengniu Dairy taps into China's evolving options market to manage a new era of currency volatility

As China moves to ease regulations on the movement of its currency across its borders, and the nature of the economy changes, so its authorities are also relaxing their control of the exchange rate. Increasing volatility is a major challenge for companies operating in China, especially given the limited number of strategies available to them for hedging risk. This is changing, however, and domestic companies are seeking international financial market expertise to help them create new strategies to insure against potential foreign exchange losses.

NO LONGER A ONE-WAY BET

For years the value of China's currency has been rising steadily, appreciating some 25% against the U.S. dollar between July 2005, when China dropped an explicit dollar peg, and the end of 2013. In fact, it long seemed as if it were a one-way bet.

This changed last year: onshore RMB, also called CNY, lost 2.52% of its value against the U.S. dollar in 2014 (similarly, the offshore market, or CNH, lost 2.76%). Volatility grew as the government allowed the value of the RMB to weaken. In mid-February 2014, over a six-day period, the RMB underwent its fastest correction in decades. Then on March 15th, the People's Bank of China (PBOC, the nation's central bank) widened the daily trading bank for U.S. dollars and the RMB, doubling it to plus/minus 2%.

With expected foreign exchange risks on the rise, many companies have been looking for strategies with greater flexibility to protect against both upward and downward swings in the currency. Mengniu Dairy, China's second-largest provider of dairy products to the domestic market, is one of them.

The dairy business itself in China is volatile, but until early 2014 Mengniu's concern over RMB currency volatility was limited. Mengniu does not break out the numbers, but it has a significant U.S. dollar cost base, and when the RMB rapidly depreciated early last year against the U.S. dollar, it added rising foreign exchange losses to its intensifying cost burden. To stem these, it sought to tap into newly allowed and more sophisticated derivatives products.

NEW RULES

Before rule changes in mid-2014, local companies wishing to hedge their exposure had to rely on trading in the spot market, forwards and cross-currency swaps (which were extended beyond the interbank market in January 2011) – tools far less effective than complex options in mitigating longer-term exposures.

Companies in China have been able to trade plain vanilla call options since the State Administration of Foreign Exchange (SAFE) first allowed their use in April 2011. Options buyers have the right, but not the obligation, to buy and sell currency at a specified exchange rate during a defined time period. SAFE still only allows so-called European-style options, which can only be exercised at maturity. And under these old rules, companies could only buy options, not sell them (although they are now allowed to do so under limited terms).

As currency volatility grew, it was increasingly apparent that such vanilla strategies were no longer sufficient. "You have to step back and understand the evolving derivatives markets in China and companies like Mengniu's growing interest in using increasingly sophisticated tools to mitigate currency risk and put that into context," says Beng Hong Lee, Head of Markets, China at Deutsche Bank. "It is an outgrowth of a new era of volatility for the RMB."

Mr Lee worked with Mengniu and a number of other unnamed onshore companies across the chemical, coal, agriculture and manufacturing industries to execute a series of options trades, taking advantage of a new regulation issued by SAFE that allowed banks to offer a wider variety of RMB foreign exchange derivatives trades. The trades were done on August 1 2014, the first day that the new rules came into effect. Mr Lee says that Mengniu and Deutsche Bank were preparing for the easing of regulations for several months and were eager to deploy immediately.

FROM VANILLA TO MINT CHOC-CHIP

The trade structured by Deutsche Bank for Mengniu is called an FX call spread. Such an instrument is suited to an environment in which the buyer is concerned about a currency's depreciation, but expects a level of volatility that makes the hedge uncertain. In effect, the instrument is an enhanced call option. Instead of just buying a call option if bullish, the company can simultaneously sell another call option with the same maturity, but at a higher strike price. The combination protects against the downside – though a feature of these instruments is a cap on the upside. The attraction to a company under cost pressure is substantial. While covering against losses due to downside swings, the sale of the additional option helps cover the cost of the hedge.

Mengniu found this attractive, says Mr Lee. "Local companies are not only beginning to hedge through plain vanilla outright options, but are also increasingly paying to hedge. Multinationals have long had the opportunity to buy protection, and from a bank perspective, we put a lot of effort to work with our clients to identify various cost efficient solutions that are most suited to their needs."

The strategy has paid off for Mengniu. "The increase in capital efficiency provided by our new options strategy will allow us to be more competitive in the international arena in terms of investing offshore, cross-border cash flow management, and overall balance sheet enhancement," the company said in a statement.

BABY STEPS

Mr Lee says that companies in China are just beginning to grasp the advantages of such instruments. He says the process can generally take a fair amount of preparation and explaining, long before a trade is executed. "You have to educate across the ranks of a company. Not only do we need to have the basic infrastructure in place to execute a trade in China, but we also have to help educate clients about the financial aspects of each trade," he says.

Still, Mr Lee says, while FX call spreads are standard outside of China, most firms in China are still in 'vanilla' territory. With the addition of more complicated options, the ability to manage currency risk is considerably enhanced, but only from a limited base.

Ultimately, Mr Lee says, the government's ambition to move toward capital account convertibility necessarily means that the PBOC interventions will decrease and the RMB's value will fluctuate more freely. The general consensus – including the view of Mr Lee – is that RMB will gradually appreciate over time, but greater volatility is now a fixture of the landscape, and companies operating in this environment will have to get used to hedging foreign exchange risks.

"[Previously] companies were operating in a market in which they could be reasonably sure of an appreciating RMB," says Mr Lee, "and these [vanilla] instruments were adequate enough for that era, but the world has changed."

Hutchison Whampoa: the chicken and the soup

The timing of full convertibility will ultimately be determined by the pace of reform in China's markets, reckons Hutchison's CFO

Hutchison Whampoa, founded by Asia's richest man, Li Ka-shing, is often seen by analysts, media and local shareholders as a refelection of Hong Kong's economy. So when Hutchison Whampoa announces plans to divest in Hong Kong port assets, headlines shout that the company is leaving Hong Kong.

In fact, Hutchison is no more *from* Hong Kong than it is a Chinese company. Since Mr Li bought a controlling 22.4% of the legacy British 'hong' style trading company from HSBC in 1979, it has grown into a global diversified powerhouse, with about USD50bn in annual sales and ownership of assets that include telecoms companies, health and beauty stores, real estate, a media and internet company, an oil and gas company, and an infrastructure company – as well as being one of the world's largest port operators. Under a restructuring plan announced in January, it intends to re-domicile in the Cayman Islands, where corporate law allows a higher level of dividend distribution to shareholders than in Hong Kong.

That said, Hutchison's association with China is integral. The company has grown with China and its phenomenal success tracks the opening of China's economy.

Perhaps because of its unique perspective as a global company with a legacy association with China, Hutchison views the RMB's progress toward full convertibility and status as dependent on fixing markets first. Or, as Frank Sixt, CFO of Hutchison, puts it: making sure you have the chicken before you make chicken soup.

"I'll put my cards on the table," says Mr Sixt, "I've been an unmitigated China bull for 30 years, and I've always been right. … But before the RMB becomes a major weight as an internationalised currency, everything needs to be done so that domestic Chinese markets become market- rather than policy-led; markets which function on the basis of sound regulatory frameworks allowing market-based price discovery and price setting.

"You've got to have real functioning markets in China that are the life and breath of the currency, and until you get that, I don't think there's enough of a natural demand – or, frankly, trading infrastructure support – for the RMB to become a major weight as a global currency.

"A currency has to pass acid tests in a lot of people's eyes in terms of how is it priced. You need a huge trading machine for all major classes of financial assets that are denominated in the currency. … That all has to happen first. You need the chicken before you make chicken soup."

He qualifies this. "We're getting a little bit of chicken soup in cross-border RMB transactions with pools and swap arrangements and so on. But you're never going to have the big bowl of it unless you really have the whole chicken."

CLEARING THE ROADBLOCKS

From Hutchison's perspective as a major player in China real estate, the 'policy-led' nature of controls can be visible even in everyday finance.

"It has certainly become easier to move money in to and out of and around in China and this is a solid improvement. But there is still a measure of internal inconsistency. Take in real estate construction finance. You may have a committed line, but the banker will tell you one week that you don't have access to it, without explaining why. Of course the reason is policy tightening towards lending to the property sector."

Perhaps counterintuitively, fixing this necessarily demands a concentration of political power at the top. "If you're going to accomplish anything on the level of introducing competition into the banking system, change the way the state-owned sector works, change the way municipalities are financed, continue with reforms of the stock market – all of that requires taking on huge vested interests," Mr Sixt says. "You've got to clear out the roadblocks."

What's difficult for an outsider to see, Mr Sixt says, is how much is really happening. The government has vowed to reform China's so-called shadow banking system – lending mechanisms that have emerged outside of the regulatory umbrella governing the banks – but the visibility of actions taken to control this lending is limited. In another instance, regulators vowed to introduce reforms allowing more market-based principles to drive China's huge domestic bond market. Yet the market has suffered only one default in its history. "How can that be?" he asks.

400 STORES A YEAR

Still, on the ground in China, where Hutchison is vying in fast-growing consumer segments, the liberalisation of the currency is helping to open doors. The Economist Intelligence Unit's survey shows that greater ease in cross-border transactions has been instrumental in helping companies expand into China's immense market of second-tier cities. More than half (51%) of the respondents say that the RMB's internationalisation has helped them expand their business development strategies into this arena, while 49% say this hasn't happened yet, but might become possible with further liberalisation.

Hutchison is seeing the benefits. "Our focus for growth is in the consumer sector. Easier access to cross-border RMB does help here, and it's very visible in our push to move into the second and third tier." The company's Watson stores chain is growing rapidly in this segment. About 40% of the products that Watson offers in China are own-brand or exclusive health and beauty products. They sell fast, as local consumers increasingly favour known foreign brands in the wake of health and safety product scares.

"What is amazing is the absorption rate. We have been opening about 400 stores a year for the past three years, in the second and third tier cities."

CRACKS AND FLOOD GATES

That's an astounding growth rate. Yet an accelerating pace of change abetted by even relatively small steps in currency liberalisation belies the larger issues facing China's policymakers.

"For all of the time that I've watched China, the country will always err on the side of making change very gradually and incrementally," Mr Sixt says. "Especially where the change involves great risk. … There's a long history in China of worrying about liberalisation of exchange controls. The old 16th and 17th century concern of money and silver leaving China. It's an old concern, and reflected today."

Mr Sixt notes that the three biggest growth markets in residential real estate in the world are Hong Kong, Sydney and Vancouver – all from mainland money buying property overseas.

"It has long been the case that if you've opened up cracks, you've tended to create flood gates. If you had a fully exchangeable currency, those sorts of flows could really affect the value of the currency."

When will the RMB become fully convertible?
"In our lifetimes."

Zurich's slow dance to the RMB world

The global insurance industry's role in the internationalisation of the currency is limited by China's controls, while full convertibility is some way away

Zurich Insurance Group has done well in China. The Swiss-based company bought a 20% share in New China Life between 2001 and 2007, starting with a relatively small stake of USD39m. In 2011 it began reducing its holdings, selling a 5% stake for about USD450m. It sold its remaining shares to investors in 2013, with net proceeds of some USD1.5bn.

SLOW, SLOW…

Those are spectacular returns, and evidence that Zurich is making the most of its opportunities in China – a market where foreign insurers nevertheless face challenges to growth. There are some 20 foreign general insurers in China, which between them have approximately 1% market share. A similar number of foreign companies selling life insurance have formed joint ventures with Chinese partners with 50% stakes. Together, these companies comprise less than 2% of the market (though AIA, classified as a Chinese company, has more than a 3% market share). Growth has been tough for the foreign players for a combination of reasons, including regulatory restrictions and foreign insurers' drive to build profits rather than pursue market share.

"Is investing in China for an insurance company driving the need for a convertible RMB?" asks Geoffrey Riddell, a member of Zurich Insurance Group's executive committee and chairman of its Asia-Pacific, Middle East and Africa businesses. "The answer is 'not really'. As long as insurers are doing business in RMB, it's a closed cycle. The only piece that's relevant is [the insurance sector's] foreign direct investment into China. China is not chasing that aggressively and it's certainly not ever going to be material enough to change the way China sees the RMB."

…QUICK, QUICK, SLOW

Hong Kong, the primary market for insurance policies written in RMB, has provided some opportunity for global insurance companies. Sales in RMB-denominated insurance products have been brisk in the territory, accounting for about 11% of new insurance business written in the territory in 2013 and about 9% in 2014. Yet this market has its limitations, not least that it will begin to erode when the RMB becomes fully convertible. (Zurich does not write any RMB business based on its strict business acceptance rules.)

Most of the buyers of insurance denominated in CNH are making a bet on RMB appreciation: that the currency's rise against the U.S. dollar over time will allow for some gain. Safety is also an attraction for some mainland buyers, who apparently feel more comfortable with a Hong Kong-based financial institution – under the eye of Hong Kong's Monetary Authority – managing their policies than a mainland counterpart.

Foreign insurers in Hong Kong either issue RMB policies linked to unit trusts in China or give funds to a Chinese life insurer to manage them – the only two options that regulators have allowed them to pursue. The business tends to have very narrow margins. Chinese insurers, in contrast, can pass the funds to their mainland operations to manage, without incurring the cost of outsourcing the management.

RMB RHUMBA

None of this is to imply that Mr Riddell sees the global rise of the RMB as negligible to insurers. It is, in fact, only a matter of time before they take a bigger role, he says. Over the next five years, however, he doesn't see a major change in focus for Zurich vis-a-vis the RMB. Full convertibility would be another matter, but in his view, any short-term move toward full convertibility faces obstacles.

"There are two issues. When does the RMB become a freely traded currency and when does it become a reserve currency? The two could happen at the same time. But there are a couple of dynamics that are often overlooked."

"When we talk about a reserve currency," he adds, "we have to think of the U.S. dollar." The U.S., through its independent central bank, has the ability to print money, control cash flow and all the low-interest benefits that have come with being a reserve currency.

Yet the RMB is still a relatively small component of all global transactions, accounting for just 2.06% of all global payments by value as of February 2015, according to SWIFT. The figure for the U.S. dollar was 43.41%, while for the euro it was 28.75%. "If the RMB becomes a reserve currency, China doesn't necessarily get the freedom the U.S. has, because the RMB is such a small part of global transactions," says Mr Riddell.

"The situation as it stands suits China for now," he continues, "[in that] the government can manage the currency because of China's immense holdings of foreign exchange reserves." This power allows China's government to set the pace for financial reforms, such as the liberalisation of interest rates that support the development of a more mature bond market and allow for a gradual opening of the nation's capital account.

LET'S FACE THE MUSIC …

Returns on equity for China's mass market insurance product companies are declining as they compete in scale, Mr Riddell says. True, some foreign insurers are now vying to carve out a niche offering premium products.

"That's the sort of place where we'd want to play," says Mr Riddell. "We could compete on what we bring as a premium life insurer as opposed to being in the mainstream where the local player nearly always wins. But that gets into the question of which industries are the foreigners doing well in," he says, "and how sustainable are those winning ways."

Zurich is giving itself time to answer that question.

Jaguar Land Rover: Run-of-the-mill RMB

One element supporting Jaguar Land Rover's China expansion: treat the RMB like any other major global currency

Tata Group's move to buy Jaguar Land Rover (JLR) in March 2008 from Ford for USD2.3bn may have seemed inauspicious. The market collapse in October 2008 hit worldwide auto demand and JLR experienced a sharp decline in sales and profitability as a result.

In 2011, however, JLR announced a new investment and growth strategy which has seen retail sales grow from 241,000 units in fiscal 2011 (year ending March 2011) to 434,000 units in fiscal 2014, generating about GBP20bn of revenue and GBP2.5bn of profit before tax in fiscal 2014. Over this period, sales volumes in China grew from 12% of retail sales to 24%.

JLR has been importing vehicles into China from the UK but opened its first production facility in the country in October 2014, a joint venture with China's Chery. The plant has a capacity of 130,000 cars for three different JLR models and a joint venture-branded model. The first car the factory will make is the Range Rover Evoque sport utility vehicle, JLR's most popular model.

RMB FIRST AND FOREMOST

With the increase in sales to China and increasing internationalisation of the RMB, JLR made the move to switch from USD to RMB invoicing last year. According to Ben Birgbauer, Treasurer for JLR, "We now transact in the RMB in essentially the same way as any other currency we transact in or manage.

"We've been able to transact in RMB for sales into China, equity contributions into our joint venture, dividend payments from our sales subsidiary, hedging and cash investments. I'd actually say we're able to do pretty much everything we've wanted to do and much of it in London.

"With respect to hedging, we have a policy to hedge in descending amounts for up to five years out, where the market allows. In the case of the RMB, we presently see good liquidity in London out to-two-to three years and I'm sure we'll see that horizon move out as the market continues to mature."

OF POOLING AND PANDAS

Like several other automobile companies, including Ford, JLR has put cross-border RMB pooling loans in place (between JLR China and JLR UK) to efficiently manage cash in RMB on a corporate basis, following a pilot programme for cash pooling introduced in Shanghai in 2013.

The internationalisation of the RMB, including cross-border pooling, has "made our business with respect to China easier," says Mr Birgbauer, allowing RMB to be transacted and managed consistent with "arrangements in any other developed market."

Unlike its luxury vehicle peer, Daimler, JLR has not yet opted to tap either the offshore RMB bond market or onshore panda bonds. But Mr Birgbauer is not counting this out.

"We think it's good to diversify our investor base and the currencies we borrow in. Issuing a bond in RMB would make sense for us some time."

JLR's China story is just beginning. Growth in car sales is ebbing in China as the economy slows, but the luxury sales sector is still growing fast. According to the China Association of Automobile Manufactures, SUV sales between January and May last year soared 38% year-on-year, to 1.5m vehicles.

"We're pleased at the pace, how fast RMB internationalisation has unfolded," says Mr Birgbauer. "It has helped make our operations more efficient and enabled us to better manage currency risks."

"It's now like any other major currency to us," he says.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