Citi PERSPECTIVES

Regulatory

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WELCOME

Since the financial crisis of 2008, regulators and central banks have introduced a series of measures aimed at enhancing the stability of the global financial system and protecting the taxpayer from the fallout of any future crisis. Many regulatory reforms, which principally target the banking sector, have laudable objectives and the overall goal of improving stability is undeniably worthwhile.

However, specific elements of some of the most important regulations – most notably Basel III – have significant potential consequences for corporates. Moreover, the failure to coordinate regulatory responses to the crisis could threaten to undermine the financial stability it seeks to enhance. Indeed, differing interpretation and implementation of many global measures could have negative implications for the banking system.

Basel III

Basel III requires banks to meet the minimum capital requirements (in terms of risk-weighted assets) of 3.5% share capital, 4.5% Tier 1 capital and 8% total capital as of January 1, 2013. By requiring banks to hold more capital (as well as introducing a liquidity coverage ratio), banks' costs will increase and, as a result, pricing to corporates may have to rise and the availability of some solutions could be curtailed for some companies.

As important as the impact of Basel III is the way in which it is being implemented. Just 11 countries, including Switzerland, Singapore (subject to amendments), Japan, India (with implementation delayed until the fourth quarter of 2013), China, Saudi Arabia, Australia, Hong Kong (subject to amendments), Canada, South Africa and Mexico, met the deadline. The US implementation has been delayed and has an unclear timeline and the EU will now implement Basel III from January 1, 2014.

Staggered implementations raise costs for banks and risk giving some banks an advantage. Moreover, there is a risk of diverging national implementation of Basel III. For example, the trigger point for capital buffers and reporting requirements could differ between jurisdictions. There are also emerging individual interpretations, approaches and timelines of other globally agreed regulatory measures such as the G-20 recommendations on OTC derivatives and the G-20 recommendations on recovery and resolution planning of systemically important international banks.

The threat of Fragmentation

The increased inward focus of governments and regulators — and the priority placed on protecting taxpayers from the cost of future bank bailouts — has the potential to lead to the fragmentation of the banking industry in the misplaced belief that such measures will mitigate risks. Bank restructuring and ringfencing of assets can affect the footprint that banks deploy and therefore potentially limits their ability to operate globally for their clients.

In the EU, the Liikanen Report for the European Commission recommends the legal separation and ringfencing of deposit-taking banks from trading or proprietary investment bank activities and requires that all insured deposits (including corporate deposits in the EU) should be ringfenced. However, given the lack of progress at EU level, member states are pursuing their own reforms. France has proposed the ringfencing of speculative activities and the prohibition of certain activities, such as high frequency trading and agricultural commodities speculation. Germany has proposed the mandatory separation of proprietary trading and certain other activities, such as lending and guarantee business with hedge funds. The UK has aggressively pushed forward the Vickers Report to ringfence retail banking from investment banking and pledged to have legislation in place by the end of this Parliament (May 2015) with compliance required from 2019. Meanwhile, in the US, the Volcker Rule separates the investment banking, private equity and proprietary trading sections of financial institutions from their consumer lending arms. Such diversity in regulation across countries increases complexity and costs for banks.

There are also increasing instances of trapped liquidity or limits to flows between branch and head office because regulators want money to remain in the country. Other developments that are limiting the ability of banks to serve their customers include requests by regulators for international bank branches in foreign countries to become subsidiaries. For example, current proposals for treatment of foreign banks and foreign non-bank financial companies in the US would require the establishment of an intermediate holding company to hold all group subsidiaries in the US. This has the potential to erode global risk diversification benefits by trapping liquidity and capital and may achieve the opposite to the stated objective of a global resolution approach for financial institutions. Global transaction banks are necessarily different from retail banking operations and should therefore be treated differently to limit the impact on their corporate customers. Corporates need to be able to move money into locations where it can be effectively used — regulations that restrict corporates from pooling funds endanger that ability.

Some regulators have also sought insight into the global resolution plans of international banks. More generally, despite a stated goal of creating a more consistent global regulatory environment, numerous local requirements have been put in place.

Damage to financial markets

There is increasing legislation to boost national budgets and curb speculation to the detriment of financial markets, such as the Financial Transaction Tax (FTT) in Europe. The FTT was originally planned to cover all 27 EU member states but many — most notably the UK, which is Europe's largest financial center — have declined to participate in the tax, although 11 countries led by France and Germany still plan to introduce it.

The risk is that by increasing the cost of trading, the cost of doing business will increase for companies. Indeed, there are some concerns that corporates could reduce their level of hedging following the introduction of a FTT, increasing the risks to their balance sheets and undermining the stability of the financial system.

In the US, the US Foreign Account Tax Compliance Act (FATCA), which came into effect on January 1, 2013, but with important provisions only effective from June 2013 or January 2014, requires compliance from multinational corporates. It imposes a 30% withholding tax on withholdable payments made to non-US companies unless those entities make certain disclosures, either to the IRS or the withholding agent, which is then required to forward that information to the IRS.

Conclusion

The regulatory trends underway and new rules set to be introduced in the medium term bring significant complexity for banks — both in terms of direct compliance and due to the different approaches to implementation around the world. There are potentially profound implications for the global network of transaction banks — providing payment, trade and other services — that facilitate the global economy.

Corporates and banks grow together and rely on each other. Anything that reduces the network capability of banks for risk reasons — because of misplaced fears about the inter-connectedness of correspondent banks, for example — threatens the ability of banks to provide solutions that their clients depend on. Incompatible regulations or differing implementation of regulations could therefore create risks that damage companies' ability to function.

Citi is the world's most global bank: We combine expertise on the ground with a global footprint and infrastructure that allows us to move cash where we — and our clients — need it. We have consistently leveraged our position — in-between corporates and regulators — to engage at a global and local level to ensure that new regulations reflect the globalized economic reality of the corporate world. Corporates also have a responsibility to help regulators understand the implications of regulatory reforms. With the regulatory landscape continuing to evolve, the banking industry and corporates must strive for global harmonization to preserve the value derived from global banking networks.

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TRAPPED CASH: NOT TO FORGET THE "OTHER SIDE" OF LIQUIDITY MANAGEMENT

Globalization has dramatically changed the economic landscape. New markets have opened up and new capital has been made available for expansion in emerging markets. Many that were initially largely manufacturing sites have begun to transform into consumer markets, increasing their attractiveness for multinationals.

Emerging economies also learned from the currency crisis of the 1990s and more easily weathered the most recent global financial crisis than many developed markets. Despite challenges, they seem likely to continue to manage their exchange rates and protect their tax bases to preserve competitiveness, even as they scale the ladder in building economies based on higher value-add than low-cost manufacturing. Ultimately, with more favorable demographics than developed markets, emerging markets should be able to consolidate their growing economic power.

The trapped cash burden

The shift in the global economy towards emerging markets has tangible consequences for treasury departments. The change in the geographical distribution of cash flows has made optimization of internal liquidity a challenge because of regulatory and tax constraints and the increased breadth of companies' operations. These mismatches can result in a company facing unnecessary working capital funding needs. Similarly, capex or acquisitions could prove more expensive because of an inability to use internal liquidity effectively.

Trapped cash represents an asset that is underutilized and potentially creates a need for "unnecessary" liquidity. As a result, it is a burden on the balance sheet of a company.

For purposes of this article, we define trapped cash as both:

- Lazy cash, i.e. idle "non-earning" local cash balances in excess of day-to-day operating requirements; and,
- Constrained cash, i.e., cash that can be moved but at a cost and with time constraints.

Decision time: When to free trapped cash

When regulations restrict the convertibility and offshore movement of funds, companies are forced to redeploy and, preferably, invest the cash locally as effectively as possible to retain value until repatriation.

The spectrum of regulation, ranging from FX controls to central bank reporting, may directly affect the amount or the frequency of cross-border movements. These constraints set the boundary of what may be possible to extract from a particular market. However, the options may be further reduced by other considerations. Tax leakages, for example, often prevent companies from using trapped cash.

The primary distinction between regulatory and tax considerations is that while regulations enforce operating policies on cash movements, tax considerations do not restrict cash movements but instead result in a financial cost. Each transaction must undergo a cost/benefit analysis to determine whether it is in the best interest of the company. Just a few of the tax considerations to be taken into account when evaluating a liquidity strategy include:

- Withholding taxes: sometimes mitigated by foreign tax credit
- Thin capitalization: maintaining tax shields
- Stamp duty tax
- Deemed dividend issues

The cost/benefit analysis should also incorporate internal factors such as the cost of funds. The following depicts a deliberately over-simplified formula to gauge the benefits of using freed cash as an alternative to third party financing, assuming no access constraints:

Execution: Strategic and tactical approaches

Extracting trapped cash usually requires consideration of both structural and tactical approaches.

Cost/Benefit[1] = {[Notional Amount x (Cost of funds – Foregone returns)] – [Tax Leakages] – [Other Incremental Transaction Costs]}

Where:

- Notional Amount = freed cash
- Cost of funds = marginal cost of borrowing assuming constant capital structure
- Foregone returns = Opportunity costs of local currency onshore investments
- Other Incremental Transaction Costs = FX Bid/Ask Spreads, bank transaction fees, etc

[1] Every component of the formula will be expressed in monetary terms; a positive final outcome indicates that using internal cash is preferable to third party financing. Note that this is not exhaustive and may omit factors that could materially impact its final outcome including FX gains and losses, among other considerations.

Structural, or more strategic approaches, may involve the deployment of legal vehicles that allow companies to stretch trade payables and shorten trade receivables terms.

One solution is to lead (pay early) on payables out of a restricted jurisdiction — releasing cash from the subsidiary — and lag (pay late) on receivables into that country. This strategy delays payment into a trapped cash environment and optimizes the company's working capital. However, local regulatory and tax oversight, as well as market FX movements, must be taken into account.

One of the best ways of eliminating trapped cash is to avoid trapping it in the first place. A potential solution is to use an internal intermediary located in a free market to buy from restricted jurisdictions and sell to the rest of the world. Given the intercompany nature of the underlying trades, transfer prices should be on an arm's length basis and trade terms set in a way to avoid possible characterization of receivables as loans. Through similar intermediaries, management fees can be paid to the parent company as compensation for management support and knowledge. Some of the frequently used structures include:

- Procurement center
- Re-invoicing center
- Netting center
- Investment fund linked to internal securitization arrangements

These structures are multi-purpose as they can facilitate other objectives, such as increasing the company's procurement bargaining power, FX management and tax optimization.

Other episodic options could include local capital reinvestment, M&A, business expansion and local sourcing.

More tactical options include:

- **Cash Forecasting**: an obvious, but effective, way to avoid pumping liquidity into a country where it will be trapped is to have an accurate cash forecasting process in place
- **Optimization**: domestic pooling structures across local entities should be used wherever allowed and feasible to help offset local cash requirements
- **Yield enhancement**: relationship interest enhancement from bank deposit balances in restricted jurisdictions may help subsidize borrowing elsewhere; other investment options may include vehicles such as local currency money market funds, commercial paper, government bills, etc.
- **Funding**: Funding local businesses with intercompany loans from the parent company (or In House Bank) instead of capital injections
- **Repatriation**: Ensuring timely regular capital and dividend repatriation within the limits allowed by each jurisdiction

Finding the right solution

Whatever the approaches employed, all options should be vetted and compared with alternative solutions to determine which produce the most value for the entire company on a consolidated basis.

Citi's Treasury Advisory team often works with clients to help determine the best course of action for trapped cash. We have found that using a decision tree framework makes it simpler to maneuver through different markets and levels of restrictions in place. Using the decision tree framework, particular types of constraints may lead to particular actions. By going through a series of ever-narrower filters, the likely most appropriate solution can be found. Where local restrictions make an immediate solution near-impossible, alternative structural approaches aimed at changing the underlying nature of targeted cash flows may be the best approach.

Using this sort of decision-tree approach can be an effective way for a company to determine an optimal approach for adoption.

Holistic liquidity management

Internally generated funds will always be more competitive than external credit lines. Effective liquidity management can activate a virtuous cycle in which net financial changes decrease and credit strength, ratings and valuation improve (further improving credit spreads). Furthermore, by tapping internal liquidity, a company gives itself greater flexibility — either to respond to external shocks or to adopt more opportunistic strategies.

Strengthening oversight of funding to subsidiaries in restrictive jurisdictions, leveraging cross-border strategies to manage working capital and funding, and effective cash forecasting systems are essential components to the approach. Advanced financial structures such as intercompany netting, re-invoicing centers, in-house banks, and financially efficient trading company models are the next step to help companies overcome the problem of trapped cash.

It is essential for companies, especially those that have a mismatch between where they generate and need liquidity, which may be most companies these days, to have holistic liquidity management strategies to prevent or release trapped cash.

GLOBAL TRENDS: HOW REGULATION IS RESHAPING CORPORATE LIQUIDITY MANAGEMENT

Elyse Weiner

Global Head of Citi Liquidity Management Services, Treasury and Trade Services, Citi

Perspectives interviewed Elyse Weiner, Global Head, Citi Liquidity Management Services, on how treasurers are revisiting liquidity management strategies.

Perspectives: To start off, what are you hearing from corporate treasurers in regard to the environment they face today?

Elyse Weiner: That it is complex, changing, and challenging. This is a period of huge shifts in markets where companies are operating, generating and using cash. But, even as conditions evolve and economic uncertainty continues, the C-suite is set on achieving higher levels of operating efficiency and return.

A prime focus for treasurers of global enterprises is therefore making better use of internal liquidity resources. While the criticality of liquidity management was highlighted by the onset of the global financial crisis, market shifts are raising the bar as treasurers are being called upon to efficiently manage liquidity and funding across a wider network of operating entities, in more complex operating environments, and with an increasing reliance on technology to bring things together efficiently.

P: What has been the biggest change over the past year?

EW: More regulatory upheaval and, at the same time, greater acknowledgment and recognition of the potential downstream implications to treasury management.

First, regulations ranging from Dodd Frank to the European Markets and Infrastructure Regulation (EMIR) are being implemented and treasurers are challenged to ensure that their organizations are compliant. Second, as businesses expand globally, treasurers are trying to keep abreast of rapid changes in capital and currency controls across more markets. These controls directly impact their ability to manage liquidity efficiency and alleviate trapped cash and are especially relevant in the more highly regulated emerging and "frontier" markets into which

companies are expanding. Finally, treasurers now acknowledge the need to plan and prepare for the implications of financial industry regulation on the products and services offered by their banking partners and adapt accordingly.

A fundamental question in the minds of treasurers today is how regulatory changes, both at the national and global levels, will affect their ability to manage liquidity on a global basis, mitigate risk, and ensure an efficient capital structure.

P: Could you elaborate on why financial industry regulation should be in the forefront for corporate treasurers?

EW: The global Basel III regulatory standards on capital, liquidity, and leverage will influence how banks approach the provision, cost and return of a broad range of services – from long-dated derivatives to trade financing to cash management. While Basel III will, in all likelihood, be subject to an extended phase-in period through 2019, and some details are still uncertain, national regulators and the financial services industry are in a race to comply to ensure comfort with clients, stockholders, and bondholders.

Companies need to prepare for how banks may re-price or retreat from services that are no longer financially or operationally attractive. Trade financing is one area that has seen some pullback as USD liquidity becomes more expensive and spreads compress. On the other hand, banks are seeking out corporates for a share of their cash management business, as transaction banking requires lower bank capital and provides attractive funding under Basel liquidity ratio frameworks. Risk distribution strategies – where banks act as intermediaries between corporates and investors, rather than buying and holding assets – will increase in popularity. Moreover, the increased cost of capital will spur industry consolidation to build scale and lower costs.

Although adding more bank providers may further diversify sources of funding and requisite services, as well as dilute counterparty exposure, the operational results will be diametrically opposed to the strategy of becoming more efficient in managing internal liquidity. There is a marked trend towards rationalization and consolidation on the part of both clients and providers to build efficiencies of scale and mitigate risk through improved management processes.

While Basel III sets global principles, it's important to keep in mind that financial services and bank regulation is imposed by national regulators, at best loosely coordinated across borders. The reality is that national regulators are implementing new

The Global Basel III regulartory standards on capital, liqudity, and leverage will influence how banks approach the provision, cost and return of a broad range of services

Many companies are deciding to undertake a more regionally-agnostic view towards global re-engineering of treasury processes

standards on bank capital, liquidity ratios, leverage ratios, and bank "resolution" regimes in different ways, often imposing higher standards. One such example is the supplementary leverage ratio proposed by U.S. regulators, which effectively doubles the Basel requirement for banks. The overall objective is to ensure stability of the financial sector, but differences in regulatory regimes may in combination have further, unanticipated impacts to the free flow of capital and create a form of regulatory arbitrage amongst banks.

P: How should companies respond to this?

EW: Ultimately, external financing will become more expensive, so companies should continue to focus on diversifying their funding alternatives and achieving maximum utilization of internally generated funds by releasing cash from the operating cycle and applying it where it delivers the best return. Centralizing treasury operations and streamlining banking will help improve cash efficiency. Corporates should also take into account the impact of higher bank capital standards on their supply chain partners, which may find it harder to secure funding. Supply chain finance offers a way to de-risk the supply chain.

Perhaps most importantly, corporates must work with their banking partners to discuss the implications of Basel III and other regulations on their bilateral relationships and proactively develop strategies to drive value creation for both parties. Bank relationship management and wallet allocation strategies will need to be refined as different institutions respond in diverse ways to pricing and appetite for providing financial services, depending on how they are positioned in regard to capital, liquidity, and business scale.

P: Taking all of this into consideration, what are you seeing companies actually doing in practice?

EW: Let me illustrate by example. Many large companies are re-evaluating their internal treasury processes and current banking arrangements.

In the recent past, a common approach was to organize and manage banking on a region-by-region basis, with "overlay" liquidity pools to help consolidate operational liquidity management. With the advent of more advanced treasury structures, such as In-House Banks, and access to globally deployed technology, this approach may no longer suffice as businesses extend into new markets and operating complexity increases.

Many are deciding to undertake a more regionally-agnostic view towards global re-engineering of treasury processes and organization. For example, with effective liquidity management as a key driver, a more efficient structure may be concentration of cash by key operating currencies into the IHB, complemented by tightly coordinated management of local liquidity and funding by the central/regional treasury organization. The deployment of structures and techniques to control flow of funds can help avoid or alleviate trapped cash in regulated markets.

Companies are also deploying global cash forecasting programs for more accurate and timely understanding of local liquidity needs and better forward planning.

P: In closing, what has Citi been doing in response to these trends?

EW: As a global banking partner for multinationals headquartered in the developed and emerging markets, we often provide both services and technical advisory to help clients in the formulation and execution of treasury management strategies.

Clients are asking for increased geographic flexibility and ability to make liquidity "fungible" across more currencies and geographies. In response, we have further expanded and enhanced our global network for liquidity management, focusing on providing clients with a common experience and funneling cash into liquidity hubs where they may place treasury centers and financing vehicles, taking into consideration the unique tax, regulatory and operational requirements that drive their decision-making. Further, we have continually invested in our liquidity analytics and information delivery platforms, providing clients with real-time reporting of positions.

Clients have made a step-change in optimizing full end-of-day global liquidity across countries and regions. Several have won industry awards over the past year — partly as a consequence of deploying the functionality provided by Citi to enhance their liquidity management processes. The roadmap and milestones are reflected in Citi Treasury Diagnostics, a tool provided to clients to benchmark performance across treasury processes, identify areas for improvement, and track their progress in achieving best practice.

P: Thank you

Yigen Pei

China Head, Treasury and Trade Solutions, Citi

RMB CROSS-BORDER LENDING: NEW STRUCTURES TO UNLOCK CASH FOR BUSINESS GROWTH

Opportunities for accessing RMB liquidity continue to grow with fast-evolving regulation, supportive policies and innovative banking solutions. Especially interesting for corporate treasurers are recent developments relating to cross-border capital flows in the form of investments and loans. At Citi, we see an increasing trend for companies with RMB exposure to focus on these cross-border opportunities to unlock working capital as their investments and revenues in China grow.

Regulatory changes for cross-border capital flows

Cross-border loans from overseas to China (described in China as foreign debt) is permitted under current regulations, so long as it is within the borrower's quota, and each transaction is registered with the State Administration of Foreign Exchange (SAFE). In contrast, cross-border lending from Chinese entities has historically been far more restricted with dividends being the only way of accessing liquidity held in China. As a result, corporate treasurers have been managing cash and liquidity quite separately from their companies' regional and global treasury management structures.

Opportunities for both RMB and foreign currency cross-border lending accelerated rapidly with regulatory developments in 2012. These opportunities are summarized in Figure 1.

Market-leading case studies

The ability to lend RMB cross-border has been welcomed as one of the most important recent developments initiated by the People's Bank of China (PBOC). Companies that have participated in the pilot programs with Citi have identified valuable opportunities to release trapped cash in China and integrate RMB cash and liquidity management structures within a regional or global strategy.

Case study 1: Exchanging RMB surplus to fund foreign currency liabilities

Danone is a world leader in dairy products, bottled water, baby nutrition and medical nutrition. With sales in emerging markets reaching 60% in 2012, and a strategic focus on Asia as a key growth market, it was essential for Danone to optimize cash and liquidity management in the region. The company had built up a large onshore RMB surplus in its Shanghai-registered company, but there was no way to use this cash for intercompany financing purposes.

Danone partnered with Citi in the PBOC pilot scheme for RMB cross-border lending and obtained a PBOC RMB lending quota. Having fulfilled the necessary conditions for cross-border lending, such as being able to demonstrate a structural cash surplus in RMB with no outstanding RMB-denominated borrowings, Danone conducted its first intercompany RMB borrowing in January 2013.

In order to adhere to transfer pricing regulations, the interest rate for the loan was set with reference to the onshore PBOC benchmark deposit rate. Intercompany contracts were drawn up between Danone's group offices in China and Singapore, with dedicated accounts in RMB. The loan was then swapped into USD (Danone's functional currency for its Singapore-based holding company) by Danone's intermediary financial holding company in Paris.

Participation in the pilot scheme has enabled Danone to leverage surplus RMB in China to finance the net debt of the group's regional treasury center in Singapore. The transaction sets an important precedent both for

Figure 1: Options for Cash Repatriation from China

	Foreign Currency Cross-border Cash Pooling	Foreign Currency Cross-border Lending	RMB Cross-border Lending
Regulatory	SAFE pilot scheme	SAFE regulation, (effective 17 Dec 2012)	PBOC (People's Bank of China) regulation, effective 10 July 2013
Eligible Pilot Cities/Provinces	Shanghai, Beijing	Countrywide	Countrywide
Applicant Criteria	Regional headquarters or investment company based in pilot city	Nil	• Single entity or pool header • One of entities in pool should have Regional HQ or investment function
Borrower	Related Company	Parent Company	Related Company
Lending Quota	Up to 30% of equity	Declared dividend + parent company's portion of undistributed profits	No Quota
Lending Mode	Auto-sweeping is permitted	Transaction by transaction basis	Multi-drawdown against the quota; Auto- sweeping is permitted
Pre-condition for Implementation	Nominated by pilot bank; Pre-approved by SAFE	Nil	No PBOC approval is required

Citi has applied its deep knowledge of cross-border lending and trade settlement practices to developing practical solutions, helping multinationals trading with China free up and make better use of their cash flow

Danone and other multinational corporations seeking to leverage RMB balances for group financing and strategic growth.

Case study 2:
Integrating RMB into overseas multi-currency notional cash pooling
A leading global confectioner based in the United States wanted to include the proceeds of its RMB cross-border loan in its global multi-currency notional pool. A multi-currency notional pooling solution enables multinational companies to manage cash balances in multiple currencies as a single position, and offset surpluses in one currency with deficits in another without the need to perform foreign currency conversion.

While this technique is familiar to many companies, particularly in regions such as Asia, which are more regulated than Europe and North America, and where the number of currencies involved is greater, it has not been possible to include cash balances held in China within these structures in the past. Currently, Citi is one of only a few banks with the ability to include RMB in a multi-currency cash pool, bringing the total number of currencies that can be managed within a single notional pool to 26.

By implementing an RMB offshore multi-currency notional pool, the global confectioner was able to integrate RMB deeper into their cash and liquidity management processes. They are now also better positioned to seize opportunities arising from the continued opening of the China market and its currency.

Case study 3:
Funding RMB trade settlement
Some companies, such as Ford, are combining opportunities for cross-border capital flows with cross-border trade settlement. Settling cross-border trade in RMB brings a range of benefits to both Chinese and foreign multinationals. For example, Ford has established an important China supply base supporting its global business. Although Ford Motor Company holds surplus RMB in China, its US parent company had to exchange USD for RMB in order to pay Chinese suppliers in their local currency. The RMB cross-border lending pilot program enables Ford to match its surpluses in China with its RMB requirements offshore, optimizing the use of cash to fuel its cross-border trade with China. Today, therefore, Ford is able to improve supplier relationships and increase the resilience of their supply chain by paying in their suppliers' chosen currency.

Facilitating local, regional and global objectives

As these case studies illustrate, the relaxation of rules on cross-border capital flows open up a variety of new opportunities both for Chinese and foreign multinational corporations. Rarely is it simply a case of repatriating RMB to a company's home country; rather, we are seeing companies across a spectrum of industries leveraging cash held in China to facilitate growth, which will in turn benefit their operations in China.

With the success of these pilot initiatives so far, it is reasonable to expect that regulators in China will continue along the liberalization path for cross-border borrowing and investment. Corporate treasurers will need to keep abreast of these developments with the objective of leveraging cash balances wherever they are located as part of a regional or global cash and liquidity management strategy.

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REWRITING THE RULES: HOW NEW FINANCIAL REGULATIONS ARE EXPECTED TO IMPACT CORPORATE LIQUIDITY MANAGEMENT

In response to the financial crisis,regulators and governments worldwide have embarked on a series of measures designed to make the global financial system more robust. Two of the most significant measures are Basel III, which aims to strengthen the global banking system, and global Money Market Fund changes, including to Securities and Exchange Commission (SEC) Rule 2a-7, which are designed to better protect money market fund (MMF) investors. Both have major implications for corporate liquidity management and short-term investment strategies.

A large part of Basel III is focused on increasing the amount of capital banks are required to hold against certain assets. However, Basel III, which is due to be phased in over six years starting this year, also imposes liquidity requirements on banks. Both the capital and liquidity requirements of Basel III are designed to strengthen the banking system and should therefore increase corporations' confidence in working with large banks. However, they are also likely to have consequences that companies need to anticipate. In particular, liquidity ratio requirements will change the value of different types of deposits placed with banks. In the MMF realm, a series of reforms – following a one-year guarantee of MMFs to stabilize the market in 2008 – have been introduced after the Reserve Primary Fund 'broke the buck' in the aftermath of Lehman Brothers' collapse. For example, in 2010, amendments to SEC Rule 2a-7 aimed to strengthen MMF fundamentals by improving liquidity, reducing the quantity of lower-rated paper in MMFs and reducing the maximum weighted average maturity of portfolio holdings.

The investment industry generally viewed these measures as positive and confidence boosting for MMF investors. However, more recent reform proposals have been less enthusiastically received. It is of concern to many that further measures intended to boost investor confidence in MMFs could have negative consequences for investors and the industry.

Liquidity requirements under Basel III

Basel III introduces two key liquidity ratios to strengthen supervision of liquidity risk: the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). The LCR is designed to ensure that banks have adequate short-term liquidity and requires them to have sufficient high quality assets that can be sold to meet their requirements over 30 days. It is calculated by dividing the stock of high quality liquid assets by the net cash outflow over a 30-day time period under extreme market stress conditions. The LCR will be phased in from 2015. The NSFR has a similar objective over a one-year horizon but will not be introduced until 2018.

The implications of the LCR for short-term deposits are significant: different types of deposits will now be valued differently by banks. Under Basel III, insured retail deposits are most valuable (with an assumed 3% runoff ratio—that is just 3% of deposits can be expected to be withdrawn over 30 days). Insured corporates and financial institution (FI) deposits are slightly less valuable (with an assumed 5% runoff ratio) but given that FDIC insurance extends only to the first $250,000 in the US, such deposits represent a small category for banks.

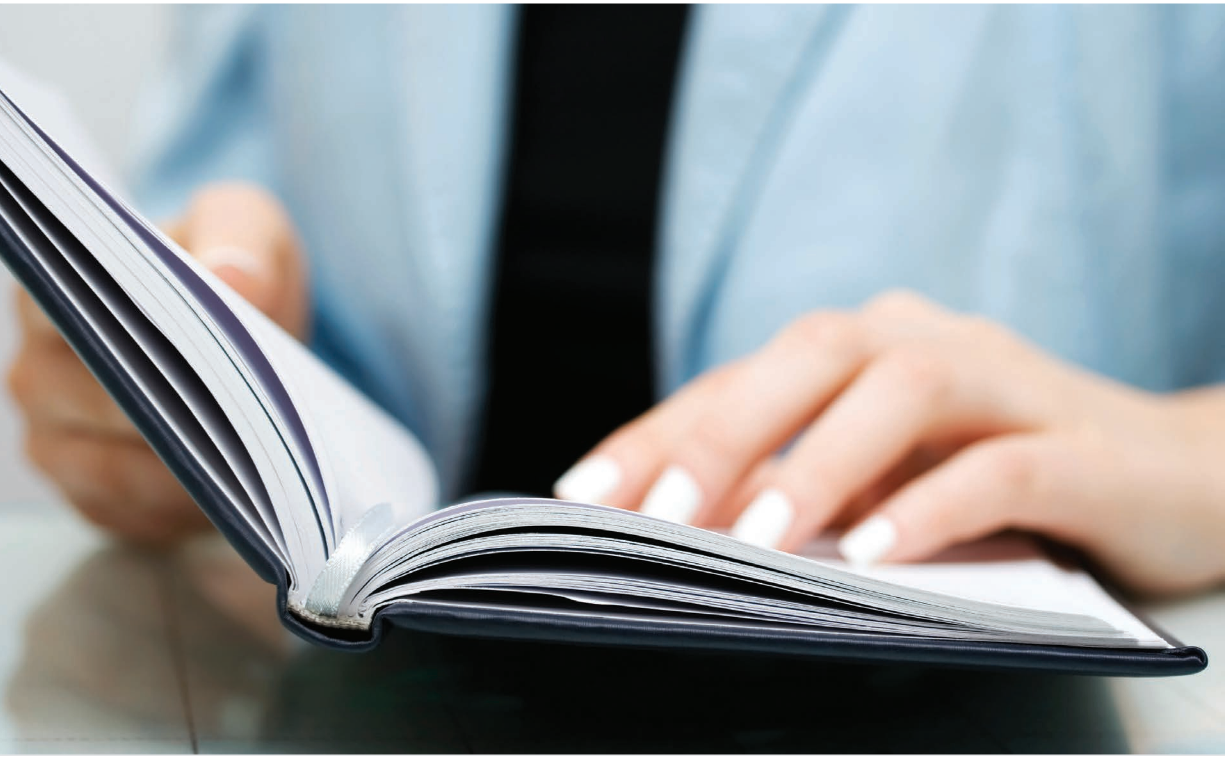
For non-insured deposits, operating accounts (associated with cash management functions such as payroll and vendor payments, or custody activity) have a 25% runoff assumption for corporations, government entities and FIs. For non-operating accounts, such as short-term time deposits or savings accounts, there is an assumption that funds would be moved relatively easily should a stress event occur (as yield is often a priority for this type of cash), with a 40% runoff rate for corporations and government entities, and 100% for FIs. Finally, deposits with a remaining maturity of greater than 30 days will have a 0% run-off assumption.

The implication of these runoff assumptions, though they are subject to change, is that the rates received on FI non-operating cash are generally expected to fall while rates for a corporations' non-operating cash should be largely unchanged. However, operating cash could become more valuable to banks than is currently the case. Consequently, banks are likely to develop a more holistic approach to client relationships in order to win clients' operating balances. Incentives to encourage clients to maintain operating balances could include discounting fees to clients who are holding sizable balances or offering higher rates to clients who also perform payments and collections through the bank. Additionally, rates on long term deposits, including certificates of deposits and call accounts, are also likely to increase.

The impact of MMF reforms

Current reform proposals from the SEC for Institutional Prime MMFs include the introduction of a floating net asset value (NAV) based on the underlying value of securities in a fund. In addition, liquidity

Banks are likely to develop a more holistic approach to client relationships to win clients' operating balances



The introduction of a floating NAV, liquidity fees and redemption gates are likely to make money market funds less attractive to corporate treasurers

fees and redemption gates (to prevent mass withdrawal of funds during stress events), should a MMF fall below certain liquidity thresholds, are proposed.

The goal of the new reforms is to make MMF investments more secure. However, the introduction of a floating NAV, liquidity fees and redemption gates are likely to make MMFs less attractive to corporate treasurers. For example, a floating NAV will require corporations to mark their investments to market on a daily basis, and will expose investors to small, but more frequent, gains and losses of principal.

They will largely eliminate one of the main attractions of MMFs: that they are stable and have a similar value to cash. Mark-to-market will increase accounting costs associated with MMFs and there may also be tax implications for gains and losses on MMF investments, although the Internal Revenue Service (IRS) has proposed changes to ease this impact.

Successive Association for Financial Professionals (AFP) surveys have shown that companies' most important cash investment policy objective is safety of principal (75% of large organizations cited it in the 2013 survey). A floating NAV undermines that and raises the prospect of a loss of principal. Furthermore, the reforms also put liquidity — companies' second most important cash investment policy objective (25% in the 2013

AFP survey)—at risk. It is important to note that no changes to MMFs have yet been approved, and given the numerous stages of the process, we anticipate that the earliest changes, if approved, would not be implemented until the second half of 2014.

Changing investment behavior

The combined effect of the introduction of Basel III and MMF reforms could be that corporations put more of their short-term cash into banks rather than MMFs. In contrast, FIs may obtain higher yields on short-term non-operating cash through MMFs. Already there has been a substantial change in corporations' investment behavior. In 2008, 25% of companies' cash was in short-term deposits and 46% in MMFs.[1] Now those statistics have reversed with 45% in short-term deposits and 29% in MMFs.[2] Factors such as yield have contributed to this trend but regulatory change has undoubtedly been a driver as well.

This trend is expected to continue. However, the MMF industry has a history of developing products to meet its investors' requirements and it could yet find a way to attract corporate cash to new types of products.

In addition to putting more of their cash into short-term deposits, corporations may start to look at other types of investment strategies, such as separately managed or customized investment accounts. These types of accounts offer the potential for higher yield than MMFs (in return for reduced liquidity) while being tailored to the risk requirements and needs of the corporate.

Within the banking sector, there has been ongoing product development to reflect the changed value of various types of deposit to banks. For example, Citi® Liquidity Management Services plans to launch a call account with greater than 31 days notice to withdraw cash. Given the notice period and current interpretation, the account has a 0% runoff assumption in LCR calculations. As a result, Citi Liquidity Management Services is able to reward clients with a higher yield in exchange for reduced liquidity.

Similarly, Citi Liquidity Management Services has enhanced its cash management billing platform so it can reward higher balance clients with lower fees. Fees are tiered as an incentive to leave operating cash with the bank and encourage greater use of operating services. Banks are also enhancing their Earnings Credit Rate (ECR) products (which offer clients fee offsets in lieu of interest, often at a higher rate than the interest would pay). Uniquely, Citi Treasury and Trade Solutions allows its clients to offset a broad range of fees, including US and Western European Cash fees, Standby Letter of Credit and Custody fees, and it expects to expand the range of transaction types that benefit from such arrangements in the future.

[1] Source: AFP 2013 Survey

[2] Source: AFP 2013 Survey

In undertaking the challenges posed by Basel III, Citi enhanced its cash management solutions so that treasurers may potentially benefit from these all-encompassing regulatory changes

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