Foreign Currency Fund Management in China

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Tim Liu's expertise as a liquidity and liability product manager is backed by several years spent implementing Citibank solutions. Tim now focuses on creating, designing and developing foreign currency liquidity products and keeping his solutions at the forefront of China's foreign currency regulatory framework.

Since reforms were initiated, China's imports and exports have increased at astonishing speed - from USD 289.9 billion in 1996 to USD 831.9 billion in 2006. Eighty percent of this trade is conducted by multinational corporations (MNCs).

For these MNCs the flow of funds is a vital component influencing every aspect of business operations. As businesses chase quicker development, the scale of the MNC in China increases continuously often creating funds management problems. Today, older funds management styles cannot adequately handle central foreign currency (FCY) funds management, control volumes or deal with today's network size. MNCs face the problem of how to create a centralized funds management operation at the heart of an enterprise for the long term.

The four main methods used by MNCs in funds management today are: (1) centralized payment and collection, (2) separate payments and collections, (3) Clearing Centres and (4) Finance Companies. Previously, as FCY regulations were different from those governing RMB centralisation, MNCs divided funds management activities into RMB funds management and FCY funds management. With relaxation of regulations for RMB funds, banks are offering mature management products for RMB funds such as entrust loans, RMB cash pooling, RMB speed collection and RMB centralized payment processes, amongst others.

These cash management products have significantly improved the previously difficult experiences of many sub-entities such as duplicate subsidiary accounts, poor control of funds, inflexible investments, loan repetition, dispersible deposits, sluggish financing and low funding efficiency. The implementation of these cash management products has also significantly improved the forecast accuracy of medium and short-term RMB funds.

The Current Status of FCY Fund Concentration

With these cash management products laying a firm foundation for centralized RMB funds management MNCs have turned their attention to centralized management of FCY funds. Unlike RMB funds cash concentration, FCY funds centralisation is still at the pilot stage. As FCY funds management is regulated by a country-level regulator, MNCs face the following four issues:

1. Non-trade FCY Sale and Payment Management

Most MNC's core non-trade foreign exchange transactions revolve around (1) shared expenses such as internal management fees, special permits, usage fees and advertising expenses and (2) monetary advances such as training fees, offshore training expenses, foreign personnel wages and insurance. The State Administration of Foreign Exchange (SAFE) general principle for verifying non-trade FCY transaction is to inspect documentary evidence. However, the authorities have found that such exchanges are based on the orders or internal agreements of MNC headquarters. Most MNCs cannot provide evidence such as formal contracts or invoices from external parties to prove transaction authenticity.

2. Centralized Management of FCY Sale and Payment

Central processing of payments and collections is a common global model used by MNCs to lower funds management operating costs, raise operating efficiency and to consolidate buying, selling and settlement. China MNCs hope to adopt this model and consolidate processes for FCY payments and collections across all company entities through regional Shared Service Centres (SSCs). Currently, the authorities are formulating the criteria for conducting FCY pooling, including unifying processes and procedures for FCY verification, setting quotas on FCY current accounts, examining declarations on international payments and collections and export rebates.

3. MNC FCY Fund Concentration

Automated concentration of foreign currency funds is today achieved mainly through banks' cash pooling structures. Funds are pooled or swept to headquarters and group entities automatically. Due to China's rule prohibiting direct borrowing between related business enterprises, there are fewer obstacles to performing FCY fund concentration via a bank or a financial institution. The authorities have loosened regulations on FCY cash pooling as demonstrated by the passing of the Pudong Nine measures in 2005.

4. Management of Outsourcing for MNCs

To lower costs and remain competitive globally, MNCs outsource non-core businesses like purchasing, production and sales to low-cost regions. Since FCY sales and payments cannot be verified on a one-to-one basis in a cross-border outsourcing set-up, the current verification methods do not fit this model.

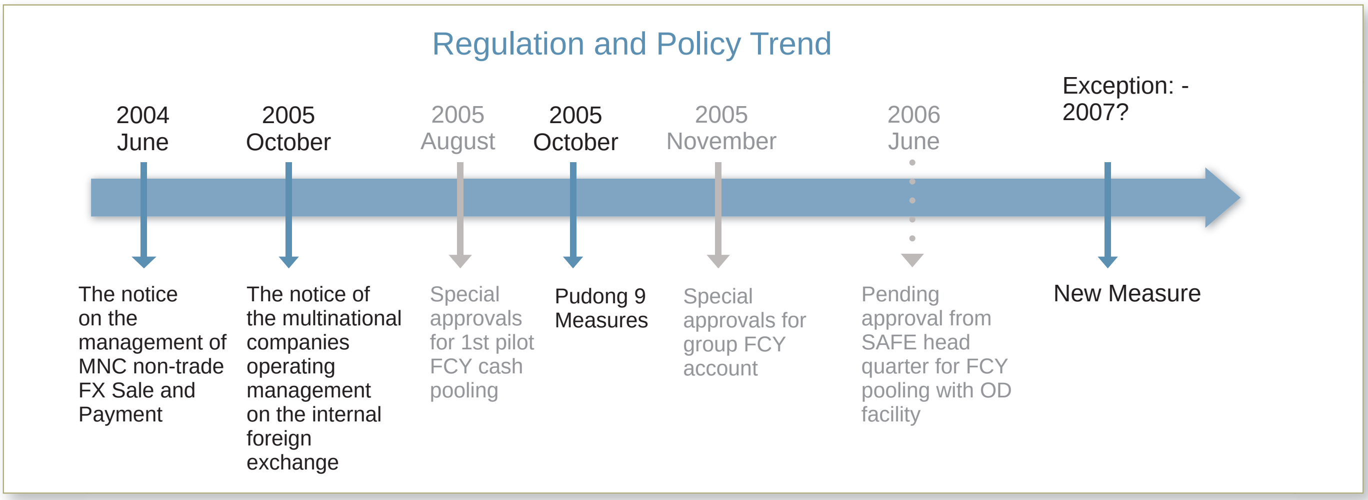
The Aim of FCY Fund Concentration

While MNCs face existing FCY concentration rules, they look forward to achieving substantial operating benefits that FCY pooling will bring. As many MNCs have experienced the benefits of RMB cash concentration, they hope to implement FCY funds centralization as well. The goal is to use centralized FCY funds management to assist companies to achieve centralized management of the group's entire funds. Also. through central FCY funds management, efficiency will improve and there will be reductions in FCY exchange costs, the cost of human resources and also reductions in operating time.

The main way to carry out FCY and RMB funds concertration is through cash pooling, of which an important objective is to create centralized dual flows between RMB and FCY cash pooling.

Regulation and Policy Trend

As China is focused on outward trade, the authorities recognize MNCs increasingly urgent need to centrally manage their FCY funds. SAFE has introduced



9 initiatives that address the ability of group enterprises to manage FCY funds centrally since 2003. These measures are in line with SAFE's policy of gradual adjustment that is supervised and controlled across the total volume of funds in the market.

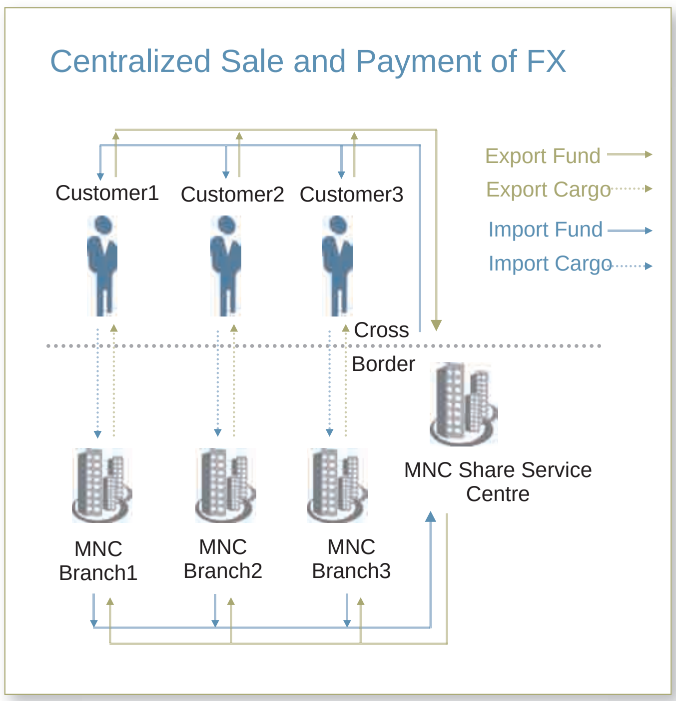
Included in these measures are《State Administration of Foreign Exchange Notice of Non-trade FX Sale and Payment》62nd 2004-6-29;《State Administration of Foreign Exchange Notice of Multinational Company of Inner Foreign Exchange》 (No.2004-104) 2004-10-18; 《State Administration of Foreign Exchange Nine Measures about Pudong》(2005-10-22) .

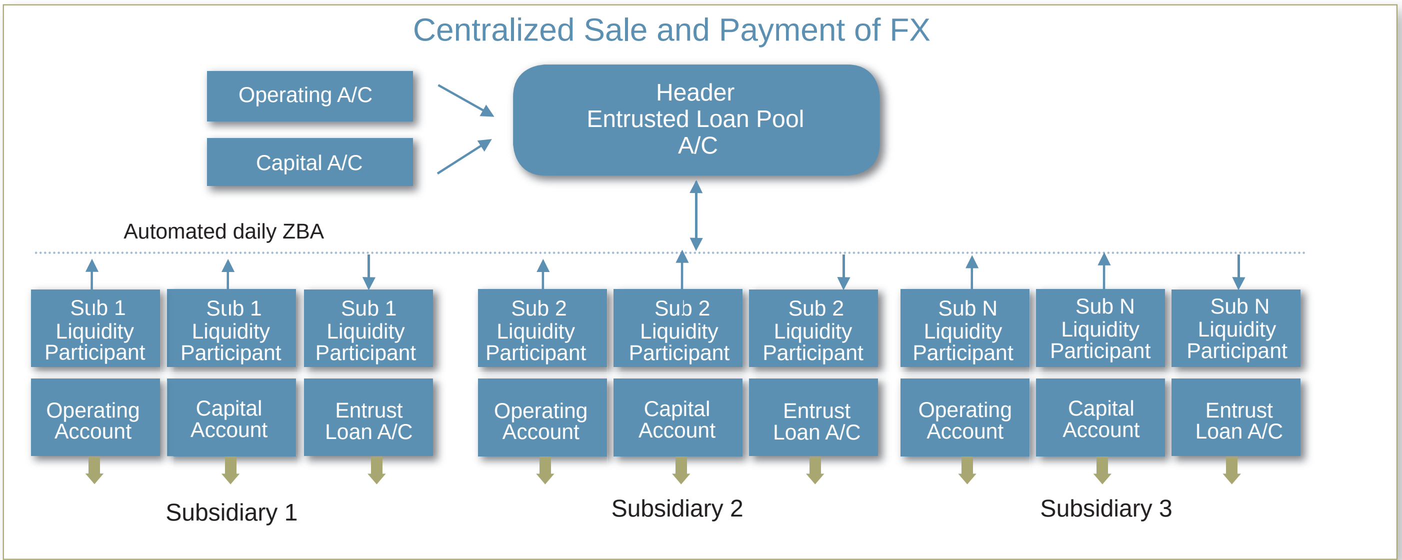
A barrier to MNC offshore outsourcing is that regulators cannot match transactions to corresponding trade-vouchers on a one-to-one basis. Two MNCs in Shenzhen were chosen as a test case and were given approval by the regulator. During the trial period, the authorities verified the authenticity of trade transactions by checking that total import cash and cargo flow volumes were bigger than total export cash and cargo flows volumes.

The Typical FCY Fund Concentration Model

1. Centralized Payments and Collections for MNCs

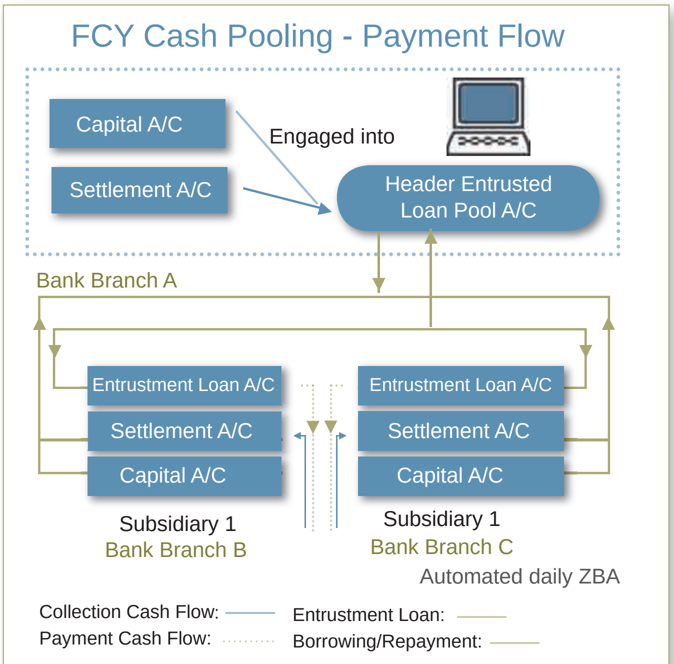
Usually, larger MNCs set up SSCs or finance companies for their China business. The regulatory threshold for approving a finance company is higher than for SSCs. Regional MNC headquarters can use SSCs or finance companies to process foreign exchange for group entities. As claims and export rebates are made between cities, the centralized processing of FCY currently has two main modes. One method is for headquarters to process all FCY transactions through a concentration account; vouchers of sale or export rebates are prepared by the headquarters' processing center. The other method is for group entities to process their own FCY transactions, including verification and export rebate processing. After all FCY transactions are processed by the group entity, the funds are pooled in the headquarters' concentration account, or pushed down to the group entity account from the concentration account.





2. FCY Cash Pooling

According to SAFE's principle of separate payment and collection lines, all FCY cash pooling is conducted using entrust loans. The headquarter and sub-entities will open entrust loan header and sub-accounts respectively for a pooling structure in the concentration bank. Deposits from the sub-accounts (settlement account, capital account and entrust loan sub-account) will be swept to the entrust loan header account automatically at day's end. The bank provides intraday overdraft facilities for the sub-account's payment and the header account will sweep the payment fund to the sub-account automatically at day's end.



Case Study

Company B is a Chinese MNC in the consumer electronics-manufacturing sector. In 2004, the import and export value of company B's trade was more than USD 700 million. In order to manage the huge foreign currency fund volume, Company B implemented the FCY funds concentrations solution. Company B headquarters opened FCY entrust loan header accounts for current and capital account related items respectively. Group entities each opened FCY settlement and capital accounts at the local branch or sub-branch of the bank. The group entities also opened FCY entrust loan sub-accounts at the bank at which the header account resides. If the sub-account in this structure has balances at the bank's clearing time, the balances were swept automatically to the FCY entrust loan header account. If the sub-account made an intra-day payment and its balance was negative, the header account made an entrust loan to the sub-account. This was the first stage of Company B's FCY cash concentration structure.

After more than a year of operating the FCY cash pooling structure, Company B reduced daily deposits by about 300 million RMB with consequential interest savings exceeding RMB 30million.