CHINA'S OFFSHORE RMB MARKET
AN OVERVIEW FOR MANAGERS AND FINANCIAL PERSONNEL

By Daniel Joseph, PNC's International Treasury Management group

PNC offers a library of materials designed to bring managers and financial personnel in operating companies up to speed relative to the recent development of the offshore RMB market. This library addresses:

What has changed and where things stand now

How the changes will impact/benefit foreign companies

Why China has made these changes

What developments you can expect in the future

Prior to 2009, China's currency, the renminbi (RMB), could only be used within China; cross-border flow of the RMB was effectively prohibited. In 2009, China began changing regulations so as to facilitate the development of an "offshore" RMB market which effectively means RMB can be held outside of China and can flow in and out of China for the payment for goods and services and for certain investment purposes.

Over the short-term, this change can have a significant impact on almost all financial transactions relative to China including those related to sourcing, exporting or the movement of investment capital. Over the long-term, if seen as part of China's overall currency and financial liberalization program, the impact of the recent changes is likely to be significant not only for individual companies but for the global financial system and global economy.

EXECUTIVE SUMMARY

This paper describes the changes that have occurred including changes relative to the following aspects of the RMB market:

Trade: Trade in goods and services in and out of China can be settled in RMB. Trade finance methods are available in both onshore and offshore markets.

Accounts: RMB accounts can be opened outside of China, primarily in Hong Kong (HK) but also in other jurisdictions. Foreign companies do not need to have a legal entity established in China (or HK) in order to open an offshore RMB account.

Capital Markets: A capital market (bonds, equities, etc.), referred to as the "Dim Sum" market, has developed to permit RMB held offshore to be invested. Channels exist to raise CNH in Hong Kong and use it in the mainland. Hedging products are also available and under development.

Exchange rates: CNH is freely traded in HK, although the exchange rate has so far mostly tracked that of CNY which is controlled by the Chinese government.

WHAT CHANGES HAVE OCCURRED RELATIVE TO THE RMB?

Some call it "yuan." Others call it "RMB." Traders call it "CNY," unless it's offshore, in which case it's "CNH," at least until it moves back onshore, at which point it becomes CNY again (or does it?), all the while having never lost its true identity, which is RMB. Confused? Wondering who's on first and what's on second? The good news is that, if you do business in China, you're probably already used to that feeling.

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Like many things in China, the currency system is unique, unusual, and a bit more complicated than one would expect. Yet, also like many things in China, if you look beneath the surface and understand how and why China does what it does, it actually makes sense, at least more sense than it does at first glance.

Perhaps the best way to understand the creation of the CNH market is that China has established Hong Kong as a "Special RMB Zone" with the possibility (perhaps probability) of gradually evolving the rules until the RMB is fully convertible like other international currencies.

The table on page 7 addresses the linguistic source of confusion (which actually doesn't exist if you speak Chinese). This document will attempt to explain the confusion created by the new "CNH" designation. Perhaps the best place to start would be a comparison.

When China first started to make the transition from communism to capitalism in 1978, it didn't change the rules throughout the country. Rather, it started with one geographic area, Shenzhen, just north of Hong Kong, where it established a "special economic zone" (SEZ) that could engage in market-oriented economic activities that were not permitted elsewhere. After testing and tweaking the new rules in Shenzhen, China created SEZ's in a few more cities, and then a few more cities, and a few more after that until, 15 years or so later, the entire country was basically a SEZ.

Deng Xiaoping, China's paramount leader from 1978 – 1994 and chief architect of China's liberalization program, used the idiom "Crossing the river by feeling the stones" (muo zhi shi tou) to describe this gradual, step-by-step, trial-and-error approach to changing China's economic system. Many, indeed most, aspects of China's economy, from price controls to agriculture to equity markets, have undergone transitions in a similar fashion.

MILESTONES IN THE CNH MARKET

July, 2005: China allows RMB to appreciate.

July, 2008: After appreciating by 21% against the USD since July, 2005, RMB peg to USD reinstated due to global financial crisis.

June, 2009: Pilot offshore RMB program established covering trade among 359 companies (referred to as "Mainland Designated Enterprises" or "MDE") from 5 Chinese cities and HK and Macau.

June, 2010: Cross-border settlement program extended to 20 provinces and all foreign countries. Also expanded to cover services.

July, 2010: China again allows the currency to appreciate.

July, 2010: First Dim Sum bond from non-financial Chinese issuer.

August, 2010: First Dim Sum bond issued by a foreign enterprise.

December, 2010: MDE list expanded from 359 to roughly 67,000.

April, 2011: First CNH IPO issued in Hong Kong.

June, 2011: Use of CNH for settlement reaches 10% of China's total merchandise trade. CNH deposits in HK reach 554 billion (approx. USD 90 billion).

March, 2012: Announcement that Mainland Designated Enterprise (MDE) list will be eliminated in near future.

The box on page 2 lists some of the milestones in the development of the offshore RMB (i.e., CNH) market over the last few years. In addition to obviously following the "crossing the river…" pattern, the other notable aspect of the program has been its comprehensiveness. Imports and exports. Goods and services. Accounts and cash management. Trading and hedging. Debt and equity capital markets. The new offshore system applies to just about everything one can do with a currency. Granted, the CNH market is far from fully developed. Some activities are still off-limits and the mechanisms for conducting transactions are not yet fully developed. But for most foreign companies, dealing in CNH is going to feel more like dealing with other fully liberalized currencies (EUR, JPY, etc.) than dealing in CNY. This is a welcome and positive development. For those looking to the future, the fact that China seems to be building a balanced, well-rounded offshore market that is actually user-friendly and advantageous enough to encourage both Chinese and foreign companies to participate, is perhaps a positive sign that China is serious about getting this right.

WHERE DO THINGS STAND NOW?

The table on page 7 provides a brief description of where things stand currently (as of 12/31/2012).

Trade Settlement

Trade is almost completely liberalized and is the most liberalized part of CNH market.

Settling trade with China (imports and exports) is easily the most developed aspect of the CNH market. At this point virtually all imports and exports related to China can be settled in CNH, including both goods and services. For foreign companies exporting to or importing from China, CNH is very likely already an option worth considering, perhaps on its way to becoming a business requirement. The latest change to the trade settlement rules is the planned elimination of the MDE designation which is described below.

Trade finance

Switching to CNH does not require any change in trade finance methods.

For those trading with China, prior to the creation of the offshore RMB market, letters of credit and other such common trade finance methods were, for the most part, available not only in foreign currencies but also in CNY. The CNH market also offers access to the same range of products, with CNH denominated letters of credit being one of the fastest growing asset classes in the new CNH market in HK. For foreign businesses switching to CNH there should be no need to alter the type of trade finance that may have been used previously. The only requirement is to find a bank that can issue or settle letters of credit in CNH which is not generally difficult to find.

MDE List to be Eliminated

The Mainland Designated Enterprise status was used to control the number of Chinese companies dealing in CNH. The MDE status has been phased out which eliminates a bothersome administrative step.

When the CNH market was initiated in 2009, China instituted a requirement that Chinese exporters who wished to receive RMB had to apply for a special designation which it referred to as "Mainland Designated Enterprise" status. China then controlled expansion of the offshore market by controlling the number of Chinese companies with MDE status. By December of 2010, China had expanded the MDE list to almost 70,000 companies, which China said represented roughly 90% of China's trade.

In March of 2012, China announced that the MDE list will be replaced by a "surveillance list." This will be a list of Chinese companies that cannot participate in the CNH market because of financial concerns that might be related to taxes, solvency, etc. It is expected that the surveillance list, focused on those excluded as opposed to those included, will be a much smaller list and that this move in effect throws open the CNH market to all Chinese companies. It will also eliminate a bothersome administrative burden for foreign companies.

Accounts

Most CNH accounts are held in Hong Kong. Other recently created options include overseas branches of Chinese banks and Non-Resident Accounts within China.

For foreign companies that have two-way trade flows with China, opening a CNH account could be a logical step in terms of netting cash flows and utilizing the natural hedge that exists under such conditions.

There are actually several new ways to open RMB accounts that have emerged since the offshore program began in 2009. Brief descriptions follow:

CNH accounts in Hong Kong are probably the easiest option now. Most CNH accounts that exist to date have been opened in Hong Kong due to the territory's status as the primary clearing center for HK transactions. CNH accounts can be opened at both foreign and Chinese banks with branches in HK.

Foreign companies do not need to open a CNH account in order to make or receive CNH payments. A bank with CNH capability can make the USD-CNH exchange on the way in or out of China such that the foreign company does not have to actually hold the CNH in an account.

CNH accounts with the overseas branches of Chinese Banks are less common as Hong Kong is more direct and accounts can be opened with a foreign bank. CNH accounts can also be opened with the overseas branches of Chinese banks, such as the New York branches of the Bank of China, Industrial & Commerce Bank of China, etc. Any transactions conducted via such accounts will be routed through Hong Kong. In practice, the decision as to where to open the CNH account comes down to a foreign company's preference to work with a foreign bank with branches in HK or the overseas branch of a Chinese bank.

Non-Resident Accounts

Due to administrative burdens, there are relatively few of these accounts.

In the past, only companies with legal entities established in China could open a bank account in China. The NRA is an account opened by a foreign entity that does not have a legal entity established in China. Funds in an NRA can be used to settle transactions in China. The administrative burden is fairly high such that it can be difficult to manage an NRA without having personnel on the ground in China (in which case you would likely have a legal entity in China and could open a regular bank account). NRA's have proved to be far less popular than CNH accounts in HK.

FX Trading and Exchange Rates

Unlike CNY, CNH is freely traded. Yet it tends to track the CNY exchange rate because generally CNH has to become CNY again to be used. However, significant deviations between CNY-USD and CNH-USD rates have occurred and might be indicative of future trends.

The Chinese government maintains a trading band in order to control the exchange rate in the onshore market (CNY). This band does not apply to CNH which means that CNH is freely traded and market-priced in HK. However, because China continues to tightly control how CNH can be repatriated to the onshore market, and uses outside of China remain limited, we can expect CNH to trade close to the CNY value over the near term because holders of CNH know that ultimately they will have to use it at the CNY value.

Having said the above it should also be noted that significant deviations have already occurred between the CNY-USD value and the CNH-USD value, suggesting that, over the longer term, the CNH market will be a catalyst for a more free-market orientation for the RMB (see below for more on this topic).

Also worth mentioning is that the People's Bank of China (PBOC; China's central bank) recently announced that the trading band for the USD-CNY value has been widened from +/- 0.5% per day to +/- 1% per day. The announcement included several other small regulatory changes that together would seem to constitute another small but important step toward making the RMB a freely-traded currency and also suggests that, even in the shorter term, greater volatility in the CNY-USD exchange rate is possible.

Hedging

The ability to hedge directly (i.e., DF instead of NDF), in a freely traded market, should in the end make the CNH hedging market more flexible and cost-effective.

Prior to the development of the offshore market, there was no way to directly hedge RMB from outside of China. Instead, a hedging product known as a "Non-Deliverable Forward" (NDF) had to be used (see box on the right). Due to the lack of restrictions in the CNH market, a broader array of hedging products is available, including deliverable forwards (DF). As a direct hedge, a DF contract is likely to be less expensive for foreign companies than a comparable NDF which means formal hedging will be more affordable for foreign companies.

For currency markets in general, and for hedging products (forwards, options, etc.) in particular, the more volume in the market the better, as it is easier to match buyers with sellers. The CNH market, while having fewer restrictions in terms of regulations, is still relatively early in terms of developing volume. At this point the market is fairly liquid out to 1 year, but needs to build more volume to be able to support a greater variety of hedging products at longer durations. Given trends relative to the growth of the RMB market, it would seem only a matter of time before longer duration hedges are more readily attainable.

Capital Markets

Foreign corporations can issue bonds in the CNH market. CNH IPO's have occurred, but only by Chinese companies thus far. Borrowing CNH from banks in HK to be used in mainland China remains highly restricted.

Technically, China could have liberalized cross border payments in RMB without supporting the creation of an offshore RMB capital market. But that would have been short-sighted. Without opportunities to invest RMB offshore, there would have been no incentive to hold RMB in offshore accounts which would have severely limited the attractiveness of the entire offshore RMB proposition.

FORWARD CONTRACTS: DF VS. NDF

Forward contract: Buyer (seller) of the forward contract agrees to buy (sell) a certain amount of a currency at a specific value at a specific date in the future. For example, a contract to buy RMB 1 million in 90 days at a rate of 1 USD to 6.23 RMB. The forward contract is designed to protect the parties involved against unanticipated changes in the exchange rate. Two important distinctions among forward contracts are whether they are "deliverable" or not. The main difference is as follows:

Deliverable Forward (DF): When the contract comes due, the buyer actually uses the designated currency (for this example, USD) to buy the purchased currency (RMB); buyer actually takes delivery of the purchased currency (RMB).

Non-Deliverable Forward (NDF): Used in situations where currency restrictions make it impossible for the buyer to actually take delivery of the purchased currency. Often used when dealing with the currencies of China, India, Brazil and other emerging markets. When the contract comes due, instead of the buyer receiving the purchased currency, the buyer receives (or has to pay), in USD, the gain (or loss) that occurred due to any movement in the exchange rate. Using the same example described above, if the USD-RMB exchange rate at the maturity of the forward contract was 6.13 to 1 (as compared to the contract strike price of 6.23 to 1), the buyer of the contract would receive $2,618.49 RMB 1MM/6.23 – RMB 1MM/6.13), which would compensate for the change in the exchange rate that occurred after the initiation of the forward contract.

China's commitment to supporting an offshore capital market can be taken as yet another sign that, although the CNH market started small, from the outset China has been committed to developing a balanced, well-rounded offshore market that could serve as a natural stepping stone to a fully liberalized currency.

"Dim Sum" is the nickname that has been given to the capital market activities denominated in CNH in HK. The Dim Sum bond market is theoretically open to any issuer, although, if the proceeds are to be used in China, permission must be obtained to transfer the funds across the border.

To date the Chinese government and Chinese banks have been the most frequent issuers in the Dim Sum bond market, but there have been many corporate issuers as well. The corporate space has been dominated by Chinese companies but also includes foreign firms such as McDonald's and Caterpillar.

Recent coupon rates have been in the 3-4% range which compares favorably to the primary alternative RMB credit source for foreign companies, bank loans within China, for which the benchmark lending rate has recently been roughly 6.5%. Certainly for any large corporate already active in the bond market with funding needs in China, the CNH market is worth consideration as an alternative to bank loans in China.

For foreign companies interested in bank debt, it will be worthwhile to follow developments relative to RMB bank loans in HK. Banks in HK can lend RMB. The borrower has to obtain permission to transfer the funds to the mainland. Any such RMB transferred into China has to meet all of China's existing regulations relative to borrowing and the use of capital for foreign enterprises in China. While such transactions have been approved, it would be an overstatement to say that this channel is wide open. Given the restrictions and challenges relative to the Chinese banking environment, the possibility of foreign banks entering the RMB loan market via HK holds the promise of better credit alternatives for foreign companies. Use of this funding option will likely broaden over time and it will be worthwhile to keep an eye out for steps in this direction.

Recent steps taken to broaden the CNH capital market include increasing the amount of offshore capital that can be invested in China's onshore capital markets (the "Renminbi Qualified Foreign Institutional Investor" program (R-QFII), which is further evidence that China is committed to making it attractive to hold RMB offshore.

China has yet to signal a willingness to allow CNH to be borrowed from banks in HK for use in the mainland. This will likely happen over time and it will be worthwhile to keep an eye out for steps in this direction.

ABOUT THE AUTHOR

Dan Joseph is an international cash consultant within PNC's International Treasury Management group. Prior to joining PNC, Dan lived in China for 12 years and has been doing business there for almost two decades. He has direct experience in sourcing, market development, FDI, manufacturing, and banking in China and is fluent in Mandarin Chinese.

For more information please contact your Relationship Manager or Dan Joseph at daniel.joseph@pnc.com or visit pnc.com/ideas.

KEY FACTS AND ASPECTS OF THE OFFSHORE RMB MARKET

	CNY (Onshore RMB)	CNH (Offshore RMB)
Definition	Traditional Chinese currency. CNY is the symbol used to designate onshore RMB for trading purposes.	Same unit of currency as CNY. Becomes CNH when used offshore according to regulations established by China. CNH is the symbol used to designate offshore RMB for trading purposes.
Geographic coverage	RMB held in accounts in China and used primarily for transactions taking place in China.	RMB held in accounts offshore and used for cross-border transactions with mainland China or for offshore transactions. Currently centered in Hong Kong. Most of the CNH in existence resides in HK. Key clearing banks located in HK. Other CNH centers under development (possibly London, Singapore, others).
Accounts	Chinese and foreign companies with a legal entity in China can open a standard bank account. Foreign companies without a legal entity in China can open a Non-Resident Account (NRA).	Foreign companies can open CNH accounts at Chinese and foreign banks in HK. Foreign companies can open CNH accounts at the overseas branches of Chinese banks.
Settlement of trade in goods and services	If a Chinese or foreign company has the appropriate legal entity established in China, that entity can • Settle in CNY for goods and services bought or sold in China. • Settle in CNA for goods and services imported to or exported from China.	Foreign corporate entities not established in China can settle import or export trade with China in CNH.
Currency trading / Determining the exchange rate	The Chinese central bank (PBOC) effectively manages the value of the RMB and limits moves in value to a narrow range on any given day. Participation in the market is limited to legal entities established within China.	CNH is traded freely. In practice has closely tracked CNY price but has shown ability to deviate as well. Participation is open to anyone with offshore RMB (CNH).
Hedging	Available only to those who have onshore RMB. Foreign companies trading with China without an onshore entity cannot take delivery of RMB acquired via forward hedging. Must use Non-Deliverable Forward (NDF) which is based on the RMB value but settled in USD.	Open to anyone outside of China. Deliverable forwards can be used as opposed to NDF's. Market is still developing; gaining in breadth; of products and depth of liquidity.
Capital Markets	Except through tightly controlled channels, that are gradually being loosened, foreign investors cannot invest in China's capital markets. Foreign companies are completely prohibited from raising funds in China's capital market but can borrow RMB from banks.	Still in relatively early stages of development. Already includes "Dim Sum" bond market in which Chinese and foreign corporations have raised CNH in HK. Chinese companies have also executed Dim Sum IPO's. Approval must be obtained to transfer funds back to China. Chinese companies have been approved to use CNH for overseas direct investment and foreign companies can use CNH for FDI into China. Borrowing CNH from banks for use in the mainland is not yet broadly permitted. Investing in the offshore "Dim Sum" market is completely open to foreigners (and authorized Chinese entities).