

China maze

Frequently asked questions about cash management in China

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China is a tricky market for the unsuspecting treasurer to navigate. It is a market where rumours abound, where rules can be easily misinterpreted and where misinformation can disappoint expectations. But it shouldn't be this way. There are many companies that run successful and efficient cash management operations in China. Where, with the help of their financial service providers, they effect payments, retrieve collections, reconcile accounts, consolidate balances and manage liquidity in an automated environment. Here I will answer a number of frequently asked questions about operating a treasury in China. But first an overview of the market.

Market overview

China is a large and fast changing market. The financial services and currency market is heavily regulated with foreign exchange controls among the strictest within the Asia-Pacific region. The renminbi (RMB), also known as yuan, is not freely convertible. China operates a managed float of the yuan, allowing the currency to trade within a very narrow band. Despite rising external pressure, we expect only a small widening of China's exchange rate band in 2004.

Various laws govern the inflow of capital, goods and services generated or owned by Foreign Invested Enterprises (FIEs). Tight control is maintained over foreign exchange flows, and regulations require all enterprises to open separate renminbi accounts and foreign currency accounts. All foreign exchange receipts and disbursements must flow through designated foreign currency accounts.

FIEs are permitted to open local currency and foreign currency accounts as outlined in the table below. Different types of accounts must be used for different, specific purposes. All foreign currency accounts are subject to a "Cap Limit", which is the maximum amount of foreign currency permitted in the account. All funds exceeding the Cap Limit must be converted to RMB, generally within ten business days. *(Please see chart on opposite page)*

Under current legislation, pooling, netting, and inter-

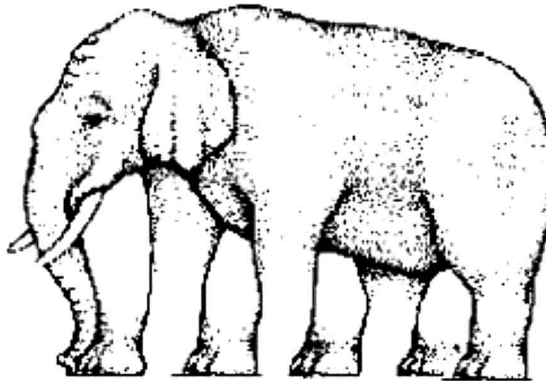
company movement of funds across different legal entities are generally not permitted. Co-mingling of funds from different types of accounts is not permitted. In general, foreign currency payments are not permitted between registered companies in China.

Paper based clearing centers run by the People's Bank of China (PBOC) exists in every major city (over 2,000) to clear intra-city RMB payments. For inter-city payments there is an electronic payment system called the China National Automated Payments System or CNAPS, but, at this stage, coverage is limited. CNAPS is supplemented by

the in-house clearing systems of each of the major local banks including the Big Four (Agricultural Bank of China, China Construction Bank, Bank of China, and the Industrial and Commercial Bank of China).

Advances are being made to China's electronic clearing infrastructure but at present there is still no single nationwide clearing system nor uniformity in bank codes or branch codes among the banks. A significant portion of domestic payments remain manual and paper-based with local formats dictated by the PBOC.

China can be confusing to the unsuspecting treasurer



How many legs does this elephant have?

Frequently asked questions

How has real-time access to accounts and account visibility improved in 2003?

The increased availability of online electronic banking systems allows nowadays for real time access to account information. However, real time payment transfer still depends on China's electronic clearing systems reaching nationwide acceptance. To date no more than 50% of bank branches across China have joined the China National Automated Payment System (CNAPS). With the introduction of the Modern Payment System (MPS) as a successor to CNAPS, real-time posting of transactions by banks is starting to become more of a reality MPS is nowadays widely used for high value inter-city payments.

CORPORATE BANK ACCOUNTS IN CHINA

Account Type	Purpose	Notes
LOCAL CURRENCY (RMB) ACCOUNTS		
Basic Account	Cash withdrawals and salary payments	Only one account permitted for each company. Cash withdrawals and salary payments must be made from this account.
Regular Account	Domestic collections and payments	Used for domestic collections and payments except for salary payments and cash withdrawals.
FOREIGN CURRENCY ACCOUNTS		
Current Account (Settlement Account)	Trade and non-trade transactions	Subject to cap limit based on a number of criteria, but generally no more than 20% of the company's previous year cross-border transaction throughput.
Capital Account	Capital injection	Subject to cap limit of the company's paid-in capital.
Loan Account	Foreign currency inter-company and bank loans	Subject to cap limit of the company's registered borrowing amount.

What are the main differences between the existing clearing system CNAPS and the new MPS system?

While CNAPS electronic fund transfers provide for real-time settlement, participating banks are unable to interface straight through to the CNAPS system. MPS does allow for direct interfaces to be built between banks and the settlement system. This way settlement can become end to end automated and straight through. Second, MPS is designed to not only handle telegraphic transfers across cities like CNAPS but to also allow for intra-city (eGiro) payments or batch payments. Moreover, the MPS batch entry payment system will support direct debits in the future. With the increased functionalities of MPS the PBOC has the ability to phase-out all domestic paper based clearing. However, whether PBOC will make it ever mandatory for all banks to use MPS when processing intra-city Giro payments remains to be seen.

How well is MPS being received?

Very well. Citigroup in China already receives 50% of all its incoming transactions through CNAPS and MPS which shows how important electronic clearing has become to our customers. The MPS system went live in two cities in October 2002 (Beijing, Wuhan) and today there are 11 more cities online including Shanghai. An aggressive rollout is expected for MPS in 2004/2005. As MPS rolls out nationwide, China will be able to leap frog from a paper based clearing system to a world-class electronic settlement system.

Are all banks required to link directly to MPS?

No, it is a matter of choice as direct and indirect connections are available. Citigroup is the only foreign bank to date

opting for a direct link to MPS in both Shanghai and Shenzhen. Through our direct link we build end-to-end integration into MPS to allow for direct clearing and automated data entry for our clients. This means our customers will have transactions settled straight through with incoming MPS payments posted on a real-time basis. Otherwise MPS transactions will be subject to manual intervention which is prone to error and delays.

In addition to CNAPS and MPS, Citigroup's strategy in China is to continue partnering with all the major local banks to assure true nationwide clearing capability. Through a purpose built Clearing Switch implemented in 2002, Citigroup now automatically sorts and routes all outgoing payments to our alliance partners through the most efficient channel. This means we are capable of making payments to any bank in China, anywhere in China, within the shortest timeframes possible.

What are the benefits of operating a Shared Services Centre (SSC) in China?

The center of gravity of business operations for most of our clients in Asia is moving fast towards China. As China continues to be one of the biggest growth opportunities in Asia, China becomes increasingly the preferred location for establishing/relocating a SSC.

Different SSC models are evolving and range from clients setting up SSC for their China domestic entities, to SSC for Greater China or even pan Asian cash management needs. Activities normally covered in China-based SSC include but are not necessarily limited to processing accounts payables, collections, credit control, account

reconciliation and customer service.

SSCs allow our clients to identify and adopt best practices into their centralized operations. The automation and centralization of activities into a low cost country like China is likely to result in significant cost reductions. Process redesign, standardization and reduction of redundant processes will drive further efficiency gains. Controls are likely to improve, while building a single interface with a single banking system will allow for further automation and cost efficiencies.

What are the disadvantages?

There really aren't any. China's infrastructure is already sufficiently robust to operate SSCs in China with high degrees of reliability. There is no doubt that China will continue to be amongst the lowest processing cost locations in the region. With the abundant availability of educated and competent staff, and further deregulation of foreign businesses under China's WTO commitments, we expect China to continue to be the biggest growth country for SSCs in the next three to five years.

The one drawback of establishing SSCs in China is that because of the foreign exchange controls in vigor it is difficult for our clients to expand their China SSC into an active regional treasury centre centralizing all their regional cash into one single cash pool.

Do companies need approval to set up a SSC in China?

Normally no specific approvals are required other than ensuring that a client's business license allows it to render services to other businesses within the group. Remember, when implementing a SSC for our clients, we are not necessarily replacing existing bank accounts or transacting on behalf of other entities. Participating entities continue to make payments from and receive collections in their own name from/into their own bank accounts. The key difference is that transaction initiation, authorization, processing and reconciliation across entities is being consolidated into one single location with one single banking interface.

What boxes should be ticked when setting up a SSC?

There are four critical stages to developing a SSC – consolidation, standardization, reengineering and automation. Unless all of these are carried out in sequence you will only achieve 50% of the total benefits that a SSC can bring. Consolidation means eliminating duplications between centers and subsidiaries, reducing physical locations and improving productivity. It also means distributing processing workload across an entire month. Standardization involves developing consistent policies and business rules and minimizing the number of IT applications that are used. Standardization also involves adopting best practices. Reengineering means organizing a company around end-to-end process and reducing the complexity of procedures. And finally, automation, the process of integrating with a single ERP and deploying Internet technology. This is where paper flow is reduced and where employees become empowered to

improve resource efficiencies. Experience shows that within Asia, companies can make cost savings of between 25% and 40% by implementing a SSC, but only if they follow these critical stages.

Where is the best place to set up a SSC in China?

Main location criteria include cost, availability of labour, stability and infrastructure. Costs across China remain low by regional standards. Infrastructure is rapidly improving towards global standards but varies widely across the country. Competent staff with multiple language skills, important when you want the SSC to handle pan-Asian cash management activities, are abundant in all larger cities. Proximity to your financial service provider is often preferred though this is becoming less important as online electronic banking platforms emerge. Finally, clients often locate SSC together with or close to their principal business activities in China in order to be close to their end users.

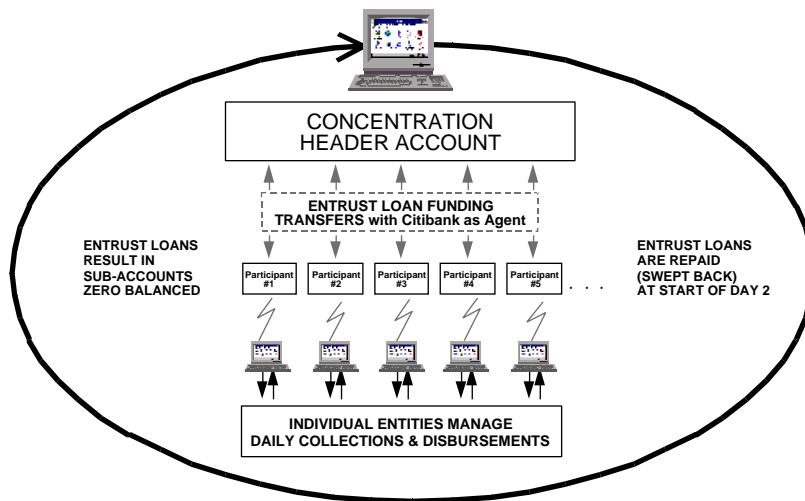
How many banks in China offer web based banking systems?

According to the People's Bank of China there are nine foreign banks in Shanghai that at the end of June this year have Internet banking licenses approved, though not every bank has yet launched web services. Regulators require that a bank put forward its web platform for specific approval. Citigroup today has over 1,000 corporate customers using its electronic banking services in China. Most of our customers have fully integrated their ERP and accounting systems with Citigroup's platforms to maximize benefits. Our Internet based banking platforms offered in China include our global platform CitiDirect® Online Banking, and a localized version called Citibank® Easy Payments. CitiDirect offers seamless and secure global access to a wide array of corporate banking services including domestic and cross border payments, receivables tracking, foreign exchange, and trade services, for both instruction initiation and reporting. CitiDirect is available in 20 languages including both simplified and traditional Chinese. Citibank Easy Payments has been specifically developed for the Chinese market and the dial-up predecessor version was rolled out as early as 2001. Citibank Easy Payments is fully bi-lingual (Chinese, English) and allows corporate clients in China to make renminbi payment transactions to beneficiaries anywhere in China. Easy Payments also delivers various payment and collections reports for clients to view or download into their computers.

What does effective liquidity management in China really mean?

Liquidity management, the number one issue for most treasurers in China today, is evolving fast. As there are few viable investment alternatives for companies in China other than bank deposits which are subject to regulated fixed rates, liquidity management tends to focus on consolidating cash positions across entities to reduce borrowing costs. Indeed the focus is to optimize liquidity usage rather than obtaining yield enhancement. Because of the PBOC controlled interest rate

ENTRUST LOAN LIQUIDITY MANAGEMENT



differential between RMB loans and deposits, potential savings from effective liquidity management are significant. The challenge is to implement cross entity liquidity pools within the existing rules and regulations.

Are inter-company borrowings allowed in renminbi?

Outright netting and pooling across different legal entities, as well as inter-company lending without an underlying transaction, is not permitted. But today, by way of entrust loans, it is possible to transfer renminbi across entities. Entrust loans are tri-party transactions between a corporate borrower, a corporate lender and a bank as intermediary, whereby the bank takes a role as documentary agent even though it does not provide funding nor take credit risk on the transaction. Using entrust loans to offset structural cash imbalances between different legal entities is becoming general practice.

The next derivative of this is to overlay an entrust loan structure over a bank's liquidity management platform. This way concentration accounts and cash pools can be set up with daily movement to and from concentration accounts denominated as entrust loan draw-downs, as such optimizing a client's liquidity position in China. Citigroup in this area delivers market leading functionality, allowing China treasurers to effectively mirror liquidity management processes common in other parts of the world. *(Please see illustration above)*

What about foreign currency liquidity management?

In June of this year the State Administration of Foreign Exchange (SAFE) Head Office issued a draft circular to all banks in China asking the banks and selected multinational companies for feedback, suggestions and comments regarding soon-to-be effective new regulations on foreign exchange current account management. The draft law tar-

gets registered regional headquarters in China with a minimum of six operating entities including wholly-owned foreign enterprises, joint ventures, co-operative enterprises and subsidiaries. Multinational corporations with headquarters located in Beijing, Shanghai and Shenzhen will be the first group of companies to be able to enjoy this new regulation once it goes into effect. The intent of the proposed regulation is to streamline the foreign currency current account management process for multinationals. The draft regulation requires all participating entities to open foreign exchange settlement accounts with the same bank to allow for cash pooling and for a more efficient use of foreign currency Cap Limits.

Just how easy is it to streamline foreign currency accounts in China?

Under the proposed new SAFE regulation, clients can set up one foreign currency concentration account, which may be a new or existing account. For the first time, balances can be swept to and from sub-accounts and the concentration account, without the need for supporting documentation that would otherwise be required for funds movements between foreign currency accounts in China. All sweeps must pass through the designated concentration account. Sweeps will not be allowed between sub-accounts.

The proposed regulation will effectively allow foreign currency current accounts to participate in cash pooling and concentration account structures. Credit interest can be paid on the consolidated or net balance of the participating entities' current accounts.

Current accounts participating in the cash pooling or concentration account structure are still subject to the overall Cap Limit regulated by SAFE. However, a customer can raise the cap limit of its concentration account by reducing its sub-account(s)' limit with the corresponding amount(s).

The June 2003 draft SAFE circular is an important step in the right direction although it only applies to foreign currency settlement accounts, not capital accounts. Consolidated Cap Limits remain in place. More, third party payments will continue to require supporting documents to be presented to SAFE which represent certain operating challenges. We continue to discuss with SAFE how to best implement the proposed foreign currency cash pooling for our clients across China. ■

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