

China's RMB

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Welcome

The value of China's currency, the renminbi (RMB), remains a bone of contention among the international community. By keeping the renminbi artificially weak, the government is accused - most vocally by the United States - of giving Chinese industry an unfair price advantage when exporting goods to other markets. However, China is taking gradual steps towards greater flexibility in the RMB exchange rate regime. In particular, development of the CNH market in Hong Kong heralds a shift towards the Chinese currency's internationalisation.

This edition of Spotlight takes the form of a question and answer session with Citi's China economist, Dr. Minggao Shen - Head of China Research at Citi Global Markets in Hong Kong - and Cheeping Yap, Hong Kong Head of Securities & Fund Services

Global Transaction Services, Citi. It also complements their recent webinar on the same topic, in March 2011. (Listen to and download Dr Shen's webinar and presentation.)

<http://www.citibank.com/transactionservices/home/region/fiacademy/fiprevious.jsp>

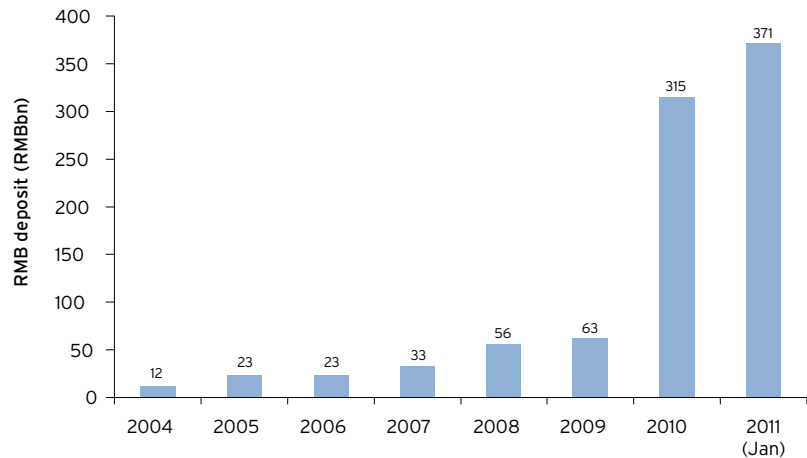
Spotlight Q&A with Dr. Minggao Shen and Cheeping Yap

Spotlight: What is the CNH market?

Dr. Shen: The RMB is traded both onshore in Mainland China and increasingly in the offshore market, based primarily in Hong Kong. As the onshore and offshore markets are subject to different levels of supply and demand, they have marginally different exchange rates. The offshore market therefore is unofficially referred to as CNH.

Since the Chinese authorities do not intervene to manipulate the offshore exchange rate, and market participants can easily open CNH accounts in Hong Kong, the market is a significant step towards internationalisation of the RMB. And it took a leap forward last year following a joint announcement on 19 July 2010 by the People's Bank of China and the Hong Kong Monetary Authority introducing a new rule that allows RMB in Hong Kong to be freely transferred between banks and accounts, initially to facilitate trade flow settlements. Renminbi deposits in Hong Kong are now growing rapidly, having shot up from RMB63 billion to RMB315 billion during 2010, and adding another RMB56 billion in the first month of 2011.

RMB Deposit Growth



Dr. Shen: The market is in the early phases of development, but we are seeing rapid growth. Crucially, the Chinese authorities will be keen to move more RMB into Hong Kong as well, not only through trade but also via foreign direct investment and other current account activities.

Should the CNH market continue to expand and reach a critical mass, the pricing power it would exert on the exchange rate does raise questions about what impact it would have on the onshore CNY market. There would then be two possible courses of action:

- The Chinese government may step in to stop or slow the market's expansion and the potential for speculation, or
- China will have to speed up reform of its foreign exchange regime, to make the domestic currency more convertible.

However, we think the CNH market will have a 10 year window of growth before the RMB becomes convertible.

In the meantime, the lack of products in the CNH market remains an issue, since without them there is a limited incentive for institutions to participate. So we expect to see the Chinese government focus on encouraging more product launches in Hong Kong, including RMB denominated bonds and prospectively RMB denominated stocks. Indeed, the Hong Kong exchange already has a framework to facilitate daily Chinese currency transactions and according to news reports, Cheung Kong Holdings Ltd., one of Hong Kong's property flagships, plans to raise at least USD1 billion by listing its yuan-denominated real estate investment trust in Hong Kong, which would make it the first IPO in RMB. Cheung Kong is still awaiting approval from Hong Kong's securities regulator and exchange operator for the listing. In addition, international financial institutions will increasingly be involved in offering some forms of structured products.

Spotlight: Is there much activity occurring in the RMB bond market?

Mr Yap: As of December 2010, a total of RMB73.8 billion of so-called 'dim sum bonds' had been issued in Hong Kong. Chinese state-owned banks led the issuance at the market's outset in 2007, with access expanded in 2009 to foreign institutions. However, volumes remained muted until 2010, when it leapt from RMB16 billion to RMB35.8 billion. Hopewell Highway Infrastructure

was the first Hong Kong-based corporation to issue CNH bonds when it tapped the market that July. McDonald's, the first foreign issuer, followed in August. Tenors range from two to 10 years, with coupons between 2.25 percent and 3.40 percent. The size of the bond offerings though nominal gave a clear indication to the market that foreign multinationals are keen to raise capital in RMB to finance their expansion on the mainland.

We also observe the emergence of synthetic RMB denominated bonds, priced in RMB but settled in US dollars. Most recent example is Chinese property developer Evergrande Real Estate Group Ltd.'s sale of RMB 9.25 billion synthetic RMB denominated bonds.

The first two months of 2011 have carried on the trend, with RMB bond issuance reaching RMB7.8 billion. And according to news reports, the state-run Chinese banks will continue to help drive growth in the Hong Kong market¹. Bank of China and Bank of Communications each established RMB20 billion offshore bond programmes earlier this year, while Agricultural Bank of China is planning to sell up to RMB10 billion of bonds over the next two years.

Dim sum bonds are offshore instruments and are not restricted by any quotas or FX controls, unlike securities in Mainland China. As such they are freely accessible - as long as an investor can set up a trading account in Hong Kong it can buy RMB bonds. Given the amount of bond issuance at this stage is much less than the volume of RMB deposits, we expect to see strong ongoing demand for new bonds as they come to market.

Crucially, trading activity is picking up as well. When the RMB bond market started it was predominantly buy and hold, with almost no secondary trading. However, indicative daily trading volume has reached US\$50 million and is on the rise, reaching \$80 million and over.

Bond trading is relatively straightforward. A broker/dealer wanting to offer RMB securities trading to retail or institutional investors would need to set up a RMB cash and securities account in Hong Kong or their home country (subject to availability). Once in place, they can carry out trading directly or work through market makers to source the bonds.

For example, Citi worked with Tokyo-based Monex Securities to help it become the first firm to offer RMB denominated government bond trading to retail investors in Japan. And this infrastructure is replicable for any broker/dealer in Europe or the US.

Spotlight: Last year also saw the first RMB bond funds come to market. Have they been a success?

Dr. Shen: Very much so. Five RMB bond funds were launched last year - two were authorized by the Securities and Futures Commission for retail distribution; the other three were privately placed, with distribution primarily through private banks. There has been huge demand for the funds, with one attracting US\$1 billion in the first four weeks, and another issued by Schroders raising approximately US\$900 million in a month. More are in the pipeline, with at least another eight to 10 RMB funds due to launch by the second quarter of 2011.

¹ CNH Tracker - More yuan bond supply seen as reforms gather pace, By Nethelie Wong, March 17 2011, <http://uk.reuters.com/article/2011/03/17/markets-yuan-offshore-idUKL3E7EG1AB20110317>

Spotlight: How long does it take to launch a RMB bond fund?

Mr Yap: It depends on where the fund is domiciled and how it is distributed, but typically the end-to-end process takes two and a half to three months. The majority of the funds we have seen are Cayman-domiciled unit trusts, plus there are a handful of Specialised Investment Fund (SIF) structures in Luxembourg. To date, clients are offering RMB bond funds primarily through private placement, with a big part of the distribution via private banks, as well as wealth management IFAs. Offerings have been targeted mostly at investors in Japan, Korea, Taiwan and Europe.

Spotlight: Is the pre-funding requirement for purchase orders for RMB bonds still in place?

Mr Yap: Yes, the normal procedure is for investors to have funds in place in the cash account prior to settlement. Essentially the Custodian will monitor the client's cash balance before releasing a trade to the market depending on the credit lines in place.

Currently, due to market liquidity concerns, RMB intra-day credit lines or overdraft (OD) facilities are available on a case-by-case basis.

Where the pre-funding requires an FX conversion, it is important to bear in mind that, while liquidity is improving, the renminbi is still an emerging market currency and there are intraday periods when the market could be tight. The largest FX transaction we have conducted in a single day is US\$300 million, but in general we are seeing US\$50 million to US\$80 million a day at present in the FX market. Therefore, with orders of more than US\$200 million it is best to spread the transaction over two to three days.

Spotlight: Operationally it is more difficult to support RMB funds because CNH is not an ISO currency, and therefore it is not recognised by SWIFT. How do you get around this?

Mr Yap: SWIFT and its SWIFT system currently only recognize International Organization for Standardization (ISO) approved codes; CNH is NOT yet an ISO approved code; only CNY is. Hence, SWIFT will not recognize CNH code. The reasons being (1) CNH is still a relatively new market with rapid developments only since July 2010. (2) As previously observed, the monetary authority of a country can submit new currency codes to ISO; according to information available, neither The People's Bank of China (PBOC) nor Hong Kong Monetary Authority (HKMA) have made any indication on this subject. As a matter of fact, SWIFT took the initiative to approach the Hong Kong Monetary Authority (HKMA) to discuss about the demand for a new currency code CNH and also other Treasury industry groups did the same. As of now, there has been no official response from the HKMA that they will apply for a new currency code i.e. CNH. As the single largest user of SWIFT worldwide, Citi is closely monitoring this and will keep clients posted of any developments.

While SWIFT messaging is all under CNY, at Citi we have created a workaround by using a combination of the SWIFT quote and a remark field that identifies the instruction as CNH rather than CNY. We have then set up our fund accounting system to recognise CNH and the remark field, so once the trades flow through to the system it can identify them as CNH, and allow the valuation and recalculation to be done via the CNH yield curve and market prices.

**Spotlight: What other developments are happening in the CNH market?
What further evolution do you expect in the future?**

Dr. Shen and Mr Yap: On the CNH product side, innovation is taking place in a number of areas. For example, 12 institutions in Hong Kong have started offering FX-linked deposits and certificates of deposit (CDs), primarily for retail investors. Tenors range from three to 24 months and payouts are from 1.5 percent to 3.5 percent interest rate.

There is also burgeoning activity in the life insurance market. Since March 2010, insurance companies have launched 13 RMB denominated life insurance products in Hong Kong. Most are settled in Hong Kong dollars, with the underlying exposure in RMB.

Going forward we expect the first Chinese currency private equity fund to launch in Hong Kong in the second half of the year, with another two in the pipeline. There is also significant anticipation in the market we will see a RMB China A-share exchange-traded fund (ETF), probably next year. That will require significant liberalisation of the Chinese Qualified Foreign Institutional Investor (QFII) scheme, but we understand the Hong Kong and Chinese governments are in discussions to make that happen. Over time we also expect to have intraday/overnight repos on RMB bonds, which could develop into a full scale repo market as the offshore RMB market grows.

The area under closest scrutiny though concerns so-called mini-QFIIs, RMB denominated funds that fund managers in Hong Kong can launch. As the funds will be denominated in RMB technically there is no FX conversion. The big question is whether the Chinese authorities will allow daily liquidity between offshore RMB moving onshore. The latest information we have is that will not happen on the first batch, which instead will still be subject to monthly liquidity. But all eyes are watching to see if China relaxes the regime after six months or a year to allow daily liquidity. And if daily liquidity does happen, then the QFII scheme will probably go through another phase of regulatory loosening.

We also expect RMB denominated equity to be listed in HKEx this year as exchange operator Hong Kong Exchanges and Clearing (HKEx) has launched a series of initiatives to prepare for the listing and trading, such as making available the exchange rates for calculating stamp duty and other trading-related fees on RMB and US dollar transactions.

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