

Cash Management in China

Introduction

Managing cash in China is challenging for reasons that include a strict – but sometimes difficult to interpret – regulatory environment, a rapidly developing financial infrastructure and evolving commercial practices. Coupled with government concerns surrounding social stability, economic prosperity and political control the cash management environment is complex.

Some of the critical cash management issues are:

- Collections – China's size and expanding commercial centers mean that customer locations and banks may not match a company's geographic footprint. There is also a strong reliance on paper instruments because of tradition and their use in information capture for cash application.
- Payments – Tradition, tied to the company "chop" as proof of payment helps support the popularity and prevalence of paper-based instruments. And cash is still a commonly used and accepted means of payment.
- Banking – There is still a strong reliance on state-owned institutions due to their sheer number of branches. Local government entities will often dictate that a company maintain an account at a specified bank for local tax payments. And despite changes opening the banking market further to foreign banks their presence in the market is still so small that it is a necessity to use local banks.
- Regulatory – Regulations may be issued from a central authority such as the PBOC (People's Bank of China) or SAFE (State Administration of Foreign Exchange), but interpretation and execution of these regulations varies between provincial authorities and banks.

This article will address many of these issues which arise in managing cash effectively in one of the world's most rapidly expanding economies. Careful planning, an established relationship with a large global bank, and strong local financial expertise can ease the process.

Business Structure and Objectives

The basic process of establishing a business presence in China is complex and time consuming. Decisions must be made as to the amount of capital to inject, location of plants or offices and staffing of the local operation. In many cases these decisions are made without consideration of their impact on banking, account setup and cash management controls. Wherever possible, treasury should be involved at the front-end to help maintain financial flexibility as the business expands, as changing the business model is not easy to do in China.

For example, there is a distinction between a manufacturing company and a trading company – a business license will be for one or the other. The license will specify precisely what types of activity can be performed by the company such as "make hammers", "sell perfume", or "undertake research". As the business grows, so do the number of licenses and with this, the challenge of managing cash for multiple legal entities. Often, the business or

manufacturing entity is established or built up from a joint venture operation and bank accounts are opened with the Chinese partner’s existing banks, branches that are within close proximity to the business, or the general recommendations and experience of local management. Changing these arrangements can be a huge challenge and can sometimes force companies to accept inefficiencies that wouldn’t exist had treasury been involved from the beginning.

Account Requirements

The number of accounts, banks used and locations will be based on a variety of factors and there is no single bank account structure that can be recommended. Local and foreign banks tailor their recommendations to the specific client situation. Accounts can be maintained in both foreign and local currency but there are significant restrictions based on the residency status of the account owner.

Companies will need to maintain several banks accounts, most likely with a combination of indigenous and foreign banks. The following grid illustrates the basic account types and their purpose.

Account Type	Purpose	Comment
RMB Basic	Mandatory: Can handle all transactions but cash and payroll transactions can only be done through a basic account	This is often a local bank close to a company's office. Only 1 basic account per legal entity
RMB General	Optional: Can handle all transaction types except cash and payroll	Limited to one account per branch. Many multinationals use a large foreign bank
Tax Account	For payment of local provincial taxes	Local governments often “dictate” the bank for this purpose, an example of convention trumping regulation
RMB Special	For foreign owned enterprises or Joint Ventures only	Used only for corporate payments; cash transactions are not permitted
Foreign Currency Capital	For investment into China	Single purpose account primarily used for capital injection
Foreign Currency Current	For all collections/payments in the designated foreign currency	Similar to a Basic Account

Each legal entity is likely to have at least two bank accounts and perhaps as many as five.

Banking Structure

The Chinese banking system has seen considerable change over the past 18 months. The four large state-owned banks (Industrial and Commercial Bank of China, Agricultural Bank of China, Bank of China and China Construction Bank) still handle the bulk of local commercial transactions. The privatization of these and other indigenous banks has been underway for some time and many foreign banks now have an ownership stake in these local institutions. In the near term this will have no impact on their cash management capabilities.

A major change impacting multinational companies is that, effective December 2006, the banking system was further liberalized, and now foreign banks can offer RMB accounts throughout the country wherever they have a branch. (This was previously restricted to 18 cities.) Theoretically, this allows the foreign banks to compete directly with the local Chinese banks until you look at a map and begin to understand the limited reach of foreign banks in comparison to indigenous banks. Also, opening a branch is time consuming and expensive. There is a capital requirement of \$25 million per branch, so the foreign banks are carefully evaluating their market strategy before proceeding with expansion. In short, relationships with an indigenous bank or banks is essential to any cash management system.

The disadvantage in branch numbers and locations has encouraged the global banks to market ideas regarding effective centralized liquidity management and electronic payment solutions to their multinational customers. Their guidance can be invaluable to companies trying to navigate the complexities of managing cash in China. Wise treasurers will leverage their existing relationships with the global banks where they have activity in the US, Europe or Asia Pacific – any new business in China may not necessarily be that profitable for the bank. The foreign banks, and most notably the large global banks have at least one strategic partner of the Big Four and often partner with all. These operational linkages will be essential in setting up any type of integrated cash management solution.

Payment and Clearing Systems

There have been significant improvements in the payment and clearing systems in an effort to modernize what has been a decentralized and paper-dominated environment. Previously, clearing took place locally, with varying arrangements between cities and there was a more automated, but closed, clearing network between the big four banks. In August 2002 the Central Bank, the People's Bank of China (PBOC) introduced a real time gross settlement system (RTGS) called the China National Automated Payment System, or CNAPS. From June 2005 the system has been nationwide with 32 provincial level processing centers in major cities and all other cities are connected to these processing centers. All banks are connected to CNAPS with the exception of some small rural credit cooperatives that provide services to the farming communities.

CNAPS encompasses a High Value Payment System (HVPS) and a Batch Entry Payment System (BEPS) that is used mainly for low value clearing (the maximum BEPS payment is RMB 20,000). In terms of development for the clearing infrastructure, nationwide check clearing using check imaging became available in the summer of 2007. Additional functionality, such as direct debits within the BEPS clearing will be rolled out by the end of 2007 making BEPS looking very much like a conventional ACH system.

What this means for cash management in China is that the “tradition” of having multiple banks for collections and payments – to expedite clearing for customer collections and to insure prompt payment for vendors – is no longer necessary from a technical perspective. However, it is harder to change ingrained habits and traditions, which include providing a physical document with a “chop” as proof of payment, and the extensive use of cash. Information capture for cash application has relied on paper instruments and these solutions have not been developed extensively – except by the larger global banks. Also, this means that having a branch “next door”, is no longer a necessity, but this common practice will also take some time to disappear.

CNAPS applies to local payments. For payments abroad, under FX regulations, all documents must be reviewed and approved by the local SAFE (State Administration of Foreign Exchange of China) before payment can be remitted. So although payments can be initiated electronically, the requirement for document approval necessitates using a local bank branch within close proximity to the office. The larger global banks are working on innovative solutions in conjunction with their banking partners, to satisfy their multinational customers frustrated with this labor intensive requirement.

Liquidity Management

A major concern for multinationals is how and how much cash to put into China, and once there managing the liquidity effectively. There are several options and considerations in liquidity management.

1) Intercompany Loans from Abroad – A straight intercompany loan from a foreign parent/majority owner is not permitted with any inbound cash treated as a capital injection. In order for this type of transaction to take place, a Capital Account is required. This is a single purpose foreign currency bank account used for investments and/or to add capital to the local enterprise. It is common for companies to have at least two foreign currency accounts – a Capital Account for injection of capital and a Basic account used for regular commercial transactions in that currency.

2) Intercompany Lending – Intercompany lending is not permitted, but can be effectively accomplished through a bank facility called an “entrusted loan”. Entrusted loans have been used in China for many years and are now considered to be a commodity product. The process is straightforward, an enterprise with excess cash puts money on deposit with its bank and receives a negotiated rate of interest on this deposit. These funds are then loaned by the same bank to an affiliate of the depositing company at a higher rate. The bank making the entrusted loan is entitled to the bid/offer spread between the two rates, and the interest rate is capped at the PBOC base rate +30%.

This form of intercompany borrowing can only be effected with a bank as the intermediary agent. The service can be extended to non-affiliated companies in which case it is referred to as a third-party entrusted loan. The “lending” company must have excess liquidity for a period of six months and places it as a loan. Although a bank will handle/administer the loan, the credit risk is taken by the company, not the bank – which can be an issue for companies with excess cash. Interest rates on entrusted loans must be set at arm’s-length to avoid the appearance of “leakage” to the tax authorities, however the lending entity would not be able

to earn more than the official interest rate. The tenor of entrust loans is generally 3 months or longer.

Many of the larger foreign banks refer to and offer the entrusted loan arrangement as a physical "pooling" service and use them as the mechanism to book intercompany loans on a daily basis – a classic ZBA service.

3) Other Options – The question arises, what is the nature of the liquidity/funding requirement and what is the tenor? If it is a new venture, there has been some relaxation of regulations. SAFE has issued rules relating to equity financing transactions through offshore "special purpose companies" ("SPCs") and their onshore investment in China. Referred to as "Circular 75" this will allow easier access to venture capital and other equity financing for Chinese business operations which require funding. However there will most likely be significant tax and legal ramifications here and could be a fairly arduous undertaking.

For short term cash needs, a local lending facility is the most feasible and practical option. The borrowing can be through an existing local bank, particularly if there is a historical relationship. The loan is repaid either directly or through an entrust facility depending on how it is structured. Alternatively, opening an account with a global relationship bank and having the borrowing facility with them is a way to begin a local business arrangement and can lead to the development of further cash management advice and services.

Payment Cards

The retail use of credit cards has increased dramatically in China and is part of the lure of China to foreign banks. On the commercial side, cards (P-cards) are not yet an option for vendor payables. Corporate cards are principally used for T&E because regulations prohibit reimbursement of expenses directly to a personal account. Companies using T&E cards must maintain an account at the issuing bank – a General Account. A major issue with cards is that they may not be honored throughout the country as some merchants will not accept cards that are not issued by their merchant processing bank. The result is that some companies provide executive or sales staff with more than one card for nationwide travel and this requires a separate bank account for each card. Until recently a separate card was needed for RMB and foreign currency transactions, but some banks are now planning to offer a universal card.

The positive side of the foreign banking presence in China is that some large global banks have ownership/joint ventures underway or planned with local bank card issuers. This change, coupled with improvements in the payment system, should lay the groundwork for innovative use of P-cards in China.

Regulatory Issues

There are a number of regulatory considerations that have an impact on cash and banking. Most notably, the lack of uniform enforcement of regulations and restrictions across the country. There can be variation across provinces and between major cities, such as Shanghai and Beijing. Other points to note include:

- There are strict controls on movement of funds from corporate to individual accounts which impacts T&E reimbursements.

- Restrictions exist on moving funds or lending between separate legal entities even if owned by the same parent. This affects liquidity management options.
- Domestic interest rates and pricing are set by the PBOC so price negotiations do not apply in setting up cash management services. This increases the importance of negotiating special services and other accommodations in lieu of price.
- SAFE – State Administration of Foreign Exchange is a key government body that manages FX regulations and must approve all outbound payments. It is not centralized in that the local SAFE in one province may interpret rules and requirements differently than the SAFE in another location.
- Many regulations are open to interpretation. Companies are strongly advised to follow the practices of others and not insist on their “rights” if they are contrary to established custom.

Summary

Managing cash in China requires a game plan that adapts sound business principles to local practices and restrictions. Developments that will influence how cash is managed in the future are encouraging, particularly improvements in the banking and clearing system. The challenge is to be open to the changes while recognizing that China is a highly regulated environment where cultural and practical interpretation of regulations.

Daniel L. Blumen – dlblumen@treasuryalliance.com

Susan A. Hillman – sahillman@treasuryalliance.com

Treasury Alliance Group LLC

www.treasuryalliance.com