CLIFFORD CHANCE

Client briefing
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An update on RMB internationalisation and Hong Kong's position as the major offshore RMB centre

Four months since we last published the briefing titled "The Internationalisation of the RMB: boosting the prosperity of the Hong Kong RMB market", China has taken further steps to enhance both the sources of and domestic investment channels for offshore RMB funds. At the same time, Hong Kong is actively gearing up to bolster its position as the major offshore RMB centre. This briefing is the latest update on legal developments in both China and Hong Kong on the road to the internationalisation of the RMB.

As a result of restrictive and effective foreign exchange policies, China has emerged to become the country with the largest foreign exchange reserves in the world. Aiming to alleviate economic and political pressure arising from huge foreign exchange reserves derived from trade surplus and striving to become a world financial power, China (which excludes Hong Kong, Macau and Taiwan for the purpose of this client briefing) has recently taken important steps to promote the use of its currency, the Renminbi (RMB), in the international market.

Currently, the RMB is not freely convertible. To become truly "internationalised", it is envisaged that the use of RMB would be gradually expanded in various stages over a period of time. From a geographic perspective, the RMB may, when it happens, first become fully convertible among neighboring countries, then among countries in the region, and finally globally. From a functional perspective, now that the RMB may be used in cross-border trade settlement under current account transactions, it may gradually be extended to capital account transactions (such as in the issue of financial products and outbound investment), and eventually function as a reserve currency just like the US dollars. Indeed, the RMB has already started to foster beyond a trade settlement currency into an investment currency. Offshore RMB holders are seeing wider investment channels for their RMB funds maintained outside China. Reportedly, the Malaysian central bank has purchased RMB bonds as its reserves. With these major developments in the pipeline, Hong Kong, being the financial gateway into China, has strong potential to flourish into a key offshore RMB market.

Sources of Offshore RMB Funds

Although the RMB is still not freely convertible, China has already gained weight in the world trade system in light of its substantial outflow of RMB funds through the following channels:

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- Border trade

As early as late 1980s, RMB has already been widely circulated among China's border trade partners. In 1997, the RMB was officially permitted to be used in the settlement of border trades among neighboring countries such as Russia, Mongolia, Vietnam, Myanmar, etc.

- Offshore consumption by PRC residents

Many Asian countries and regions that are popular to tourists have accumulated RMB paid by Chinese tourists and travelers. Among them, Hong Kong has the largest RMB reserves accrued from offshore consumption by PRC nationals. In 2003, in order to facilitate offshore consumption of PRC residents and regional circulation of RMB, the People's Bank of China (PBOC) established a settlement mechanism with the Hong Kong Monetary Authority (HKMA). To implement the mechanism, the PBOC appointed a RMB clearing bank, which currently is the Bank of China (Hong Kong) Ltd. (BOCHK), to provide RMB settlement services for Hong Kong banks to engage in RMB services such as deposit, exchange, bank cards, remittance and cheques. Similar settlement arrangements are also implemented in Macau.

- Currency swap

In order to promote bilateral trade and investment, the PBOC has, since December 2008, signed a three-year currency swap agreement with the central bank/monetary authority of each of eight foreign countries and regions (namely, South Korea, Hong Kong, Malaysia, Belorussia, Indonesia, Argentina, Singapore and Iceland) involving RMB803.5 billion to date. Under the currency swap agreements, PBOC encourages foreign central banks/monetary authorities to lend RMB so derived to commercial banks in their jurisdictions, which may further onlend to local companies in need for settlement of trade with PRC companies or investments in China.

- RMB cross-border trade settlement

On 1 July 2009, China introduced a pilot scheme allowing cross-border trade settlement in RMB, which highlights an inter-bank settlement mechanism. At first the scheme was limited to trades between Shanghai and four cities in Guangdong on the one hand, and Hong Kong, Macau and the ASEAN countries on the other. Given the success in the first stage, the scheme was further expanded on 17 June 2010 to trades between 20 provincial jurisdictions in China and globally. Cross-border trade settlement amounted to RMB108 billion in January 2011. In addition to the inter-bank channel, the PBOC further allowed foreign entities to open RMB settlement accounts with Chinese banks directly to carry out various cross-border RMB businesses as from 1 October 2010.

Previously China has to rely on the US dollars or other freely convertible currencies to settle trades with a country that also has a non-freely convertible currency. In those days, companies in both countries must first convert their local currencies into US dollars or other freely convertible currencies before settling trades between them, resulting in additional transactional cost and creating the risk of exchange rate fluctuations. The ability to use RMB to settle cross-border trades removes the need for currency conversion and represents a saving on the companies. Additionally, trade partners that anticipate the appreciation of RMB finds settling cross-border trades with Chinese companies in RMB even more attractive. Reportedly, RMB cross-border trade settlement amounted to roughly RMB506.3 billion in 2010, which represents a very substantial rise compared to the RMB3.6 billion recorded in 2009 since the scheme was launched in July 2009. It is expected that the pilot scheme will be expanded nationally and the RMB settlement amount will increase substantially further .

Statistically, offshore RMB reserves constituted by way of cross-border trade settlement exceed those derived from border trade and offshore consumption of PRC residents. This trend is likely to continue and grow even stronger in the future. Since the introduction of the RMB cross-border trade settlement scheme in July 2009, RMB deposits in Hong Kong have almost sextupled, amounting to over RMB314.9 billion by the end of December 2010. Trade settlement will remain to be the primary factor in determining the size of offshore RMB supply in Hong Kong. However, as the RMB market in Hong Kong is still in its infancy, the incredibly sharp growth rate in 2010 is unlikely to repeat in the short run. Notwithstanding this prediction, it would not be unreasonable to project that 50% of trade flow may be settled in RMB in the coming years. By 2015, cross-border trade is forecasted to reach RMB4.4 trillion. At that point, the volume of total RMB trade settlement business would hit RMB 2.2 trillion.

- RMB settlement for outbound direct investment

  Based on experiences gained in the Xinjiang Autonomous Region, PBOC launched a pilot RMB cross-border trade settlement scheme for outbound direct investment in 20 provinces on 6 January 2011.

  Under the scheme, PRC incorporated institutions intending to remit RMB funds offshore for direct investment (either in the form of upfront fees or capital funds) must obtain approval from Ministry of Commerce and National Development and Reform Commission (NDRC) and register with State Administration of Foreign Exchange (SAFE). Upon registration, the PRC institutions may apply directly to banks for remittance of RMB funds offshore. Additionally, with prior approval of the competent authorities, the PRC institutions may apply directly to banks for remittance and repatriation of RMB funds arising from the increase and decrease of capital, transfer of equity and liquidation of the outbound invested enterprises. The PRC institutions are also allowed to repatriate the proceeds of the outbound investment in RMB. It is estimated that the above procedures may take about six or seven months. PRC financial institutions engaging to remit RMB funds offshore for direct investments may be subject to special requirements imposed by the competent industry regulator.

- Listing of foreign companies in China

  Reportedly, the Shanghai Stock Exchange is planning to create an international board to allow foreign companies to list and hence to sell shares to investors in China for the first time. This may be realized as early as the late 2011, at which time international companies may have an additional source of RMB funds through listing in China.

Existing and Potential Investment Channels into the PRC

In order to diversify the investment channels for offshore RMB funds and thereby raise the incentives of offshore entities in holding RMB, China is gradually expanding the following investment channels on a systematic basis, as follows:

- Deposits

  Since December 2003, RMB clearing banks have been permitted to open interest-bearing RMB accounts with the PBOC which pays interests on the deposit of offshore RMB funds. However, this has not raised sufficient incentive to attract offshore RMB holders in holding large amounts of RMB funds. Reportedly, RMB deposits have grown to 370.6 billion at the end of January 2011.

- RMB bonds

  Since 8 June 2007, PRC banks were permitted to issue RMB bonds in Hong Kong. With approval from the NDRC and the PBOC, they were allowed to remit RMB proceeds from bond issue back into China and pay the principal and interests on the bonds in RMB within the quota specifically approved by the NDRC. So far, seven PRC banks (namely, the China Development Bank, the Import-Export Bank of China, the Bank of China, the Bank of Communications, the China Construction Bank, the HSBC Bank (China) and the Bank of East Asia (China)) have issued RMB bonds in Hong Kong, the aggregate value of which amounted to RMB48 billion. In September 2009 and November 2010, the PRC Ministry of Finance also issued RMB bonds in Hong Kong which in aggregate amounted to RMB14 billion. Reportedly, by the end of 2010, 50 offshore RMB-denominated bonds have been issued in Hong Kong and a total of RMB35.7 billion was raised.

  While the issue of RMB bonds in Hong Kong by foreign companies is only subject to the regulation of Hong Kong authorities, the remittance into China of RMB funds they raised from the bond issues will still be scrutinized by PBOC and SAFE in the absence of enabling regulations. Currently, a concrete legal framework and mechanism that allows RMB funds raised from offshore financing projects to be remitted and used in China does not exist. As such, under an unpublicized program, foreign companies hoping to do so may only apply to PBOC and SAFE for special approval on a case-by-case basis. In additional, capital investment in China using RMB derived offshore must further be subject to approval of MOFCOM. According to PBOC, 16 financing projects amounting to RMB81.4 billion have been approved in this manner in 2010, among which RMB27.5 billion relating to 13 projects have already been drawn down.

- Inter-bank Bond Market

  On 16 August 2010, the PBOC issued a notice permitting offshore central banks, RMB clearing banks and offshore participating banks of RMB cross-border trade settlement to invest in the inter-bank bond market in the PRC on a pilot basis. Reportedly, up to the end of December 2010, five offshore institutions have been approved to invest in the inter-bank market with a total approved amount of RMB 29.2 billion. The inter-bank bond market differs from the exchange-traded bond market, and works on a quotation inquiry mechanism with certain financial institutions acting as market makers. RMB funds that invest in the interbank bond market must be sourced from currency cooperation between central banks, cross-border trade and investment in RMB business. Products available on the inter-bank bond market include bonds repo transactions and cash bond transactions. Reportedly ICBC Asia has completed the first transaction under this pilot scheme.

- RMB-denominated IPOs in Hong Kong

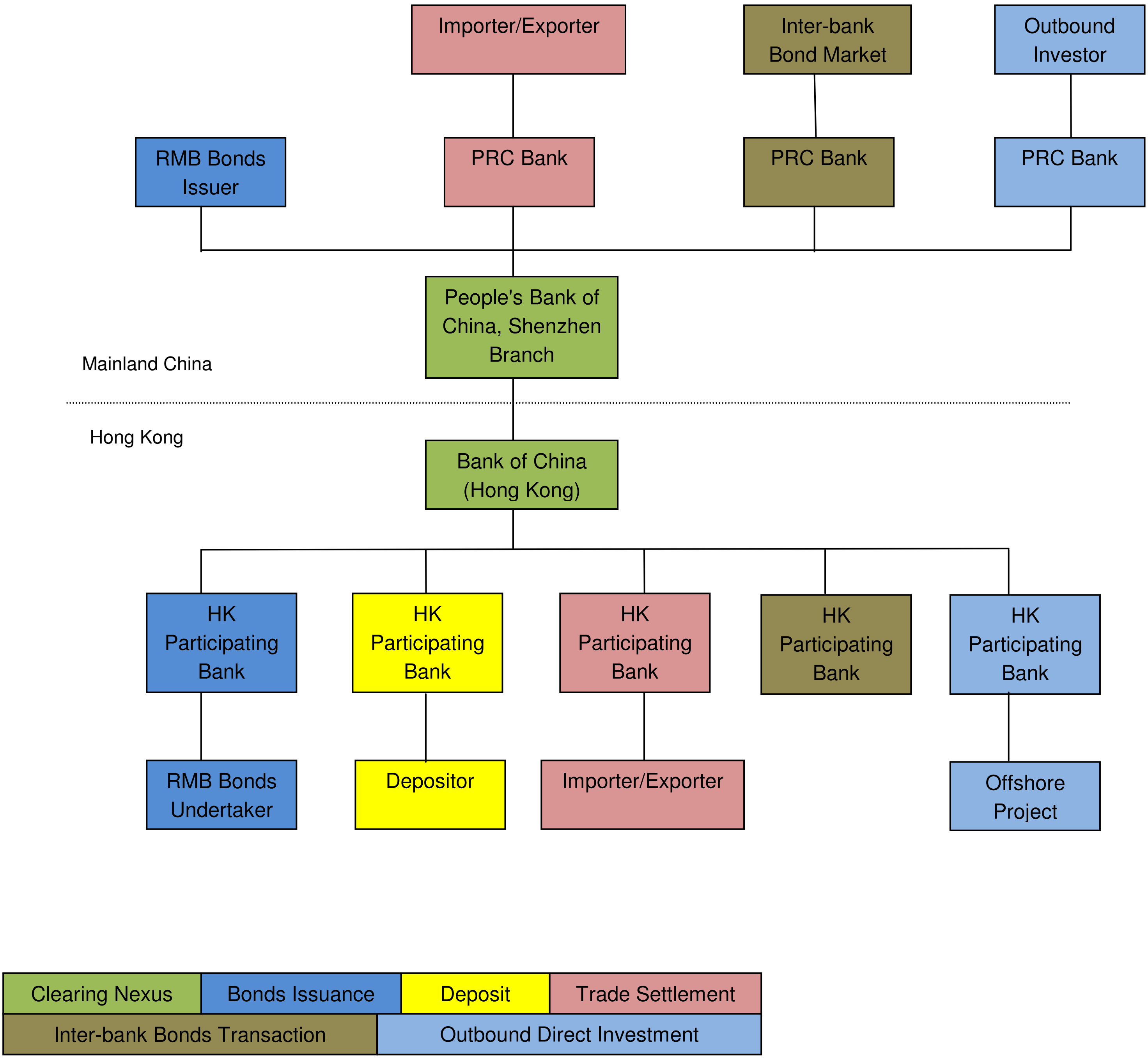
  Hong Kong has one of the largest stock markets in the world. Since its offshore RMB business will eventually extend to the equity market, Hong Kong Exchanges and Clearing Limited (HKEx) is exploring the possibility of setting up a RMB liquidity pool for those investors who do not have the currency but who are interested in RMB-denominated IPOs. HKEx plans to roll out the RMB Equity Trading Support Facility (TSF) in the second half of 2011. This is meant to be a back-up scheme to enable investors to purchase RMB-denominated shares in the secondary market with HK dollars if they have difficulty in obtaining RMB. The TSF is designed to allow RMB-denominated shares to develop without constraints arising from limited RMB availability at any given time. Tentatively, HKEx may allow subscription in Hong Kong Dollars for RMB IPOs but settlement for allotment in RMB as a means to address possible RMB liquidity constraints arising from over-subscription.

  Cheung Kong Holdings, reportedly, has already applied to HKEx for the listing of a RMB REIT, which if approved, would be the first RMB IPO in Hong Kong. In combination with the "H-share" and "Red-chip share" mechanisms, a new approach of RMB financing in Hong Kong will be expected to be opened for domestic enterprises.

Notwithstanding the above movements, the development of Hong Kong RMB products is still heavily reliant upon the huge capital market of China to support sufficient investment earnings and the operation of the flow-back mechanism for offshore RMB funds. Additionally, several Hong Kong banks have launched RMB promissory notes for the subscription of new shares.

The Key Position of Hong Kong

Hong Kong is best positioned to develop the offshore RMB market in light of its sophisticated financial market and its close proximity to China. The RMB clearing system that has been established in Hong Kong so far is as shown below:


Importer/Exporter
Inter-bank Bond Market
Outbound Investor
RMB Bonds Issuer
PRC Bank
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PRC Bank
People's Bank of China, Shenzhen Branch
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Hong Kong
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HK Participating Bank
HK Participating Bank
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HK Participating Bank
HK Participating Bank
RMB Bonds Undertaker
Depositor
Importer/Exporter
Offshore Project
Clearing Nexus
Bonds Issuance
Deposit
Trade Settlement
Inter-bank Bonds Transaction
Outbound Direct Investment

To date, Hong Kong has already developed many RMB financial products. Since 19 July 2010, enterprises and non-individual entities were also permitted to open RMB deposit accounts with qualified Hong Kong banks and exchange for RMB without limit. RMB funds were also allowed to be transferred between different bank accounts in Hong Kong. With recent deregulation, Hong Kong financial institutions have offered an increasing number of RMB financial products to Hong Kong residents including bonds, certificates of deposit, insurance plans, structured deposit, funds units and deliverable/non-deliverable RMB forwards. RMB bonds issued in Hong Kong (also called "dim sum bonds") have seen a prosperous development in the past months. The total outstanding of the Dim Sum bonds are RMB75 billion as at the end of February 2011. Reportedly, HKEx is actively preparing for the listing, trading and clearing of RMB products. Currently, two issues of RMB bonds (one by the Asian Development Bank and another by Galaxy Entertainment Group) have been listed and are being traded in HKEx, although neither is cleared through HKEx's CCASS system.

The Next Step

The mini-QFII (or RMB QFII) pilot scheme, which will allow Hong Kong subsidiaries of domestic fund management companies and securities companies to utilise offshore RMB funds to invest directly in onshore listed securities, has been a major focus of market participants. Similar to the current QFII regime, a quota mechanism would also apply to the mini-QFII mechanism so that funds channelled into the PRC market will be managed to minimize any potential negative impact on the domestic securities market.

The Hong Kong market has been preparing for the implementation of the mini-QFII mechanism. For example, Haitong Asset Management (HK) Ltd., a wholly-owned subsidiary of mainland-incorporated Haitong Securities Co., Ltd. which is listed on the Shanghai Stock Exchange, has been approved by the Hong Kong Securities and Futures Commission to establish an umbrella fund. The umbrella fund consists of a RMB5 billion sub-fund denominated in RMB, which currently invests in offshore fixed income instruments denominated in RMB. Once the mini-QFII pilot scheme is launched, this umbrella fund could establish a new sub-fund to invest in onshore RMB listed securities, such as A-shares. PBOC has apparently adopted a very cautious approach on the flow-back of offshore RMB funds and hence, the launch of mini-QFII still awaits to be seen.

China's opening of the inter-bank bond market marks the first important step in allowing offshore RMB holders to access its onshore capital market. So long as offshore RMB funds (especially those derived from RMB cross-border trade settlement transactions) continue to grow to provide enough liquidity and the permissible offshore investors in the inter-bank bond market react positively, there is reason to believe that China will further widen the investment channels for offshore RMB funds.

On 16 September 2010, China revised the regulations that govern the issue of RMB bonds by international development institutions in China (Panda bonds). As a result, RMB proceeds of Panda bonds are now permitted to be used offshore, and the principal and interest of Panda bonds may also be repaid by offshore RMB funds.

PBOC is currently exploring the mechanisms for RMB settlement of foreign direct investment (i.e. RMB associated with the establishment of foreign-funded enterprises in PRC) and foreign debt denominated in RMB (i.e. indebtedness incurred by PRC entities to foreign lenders). PRC regulators may further see the need to open up the inter-bank foreign exchange market to offshore RMB holders as a way to hedge the currency risks of holding RMB outside China.

Conclusion

The Chinese government is clearly determined to steer and realize the internationalisation of RMB. According to the 2011 government work report, China will continue to increase the use of its currency, the RMB, in cross-border trade and investment and proceed in making the RMB convertible under capital accounts in 2011. With the launch of the pilot scheme and recent deregulations, together with the anticipated relaxations in the near future, the cross-border flow of RMB is likely to become easier. This should result in more investment opportunities in the increasingly prosperous RMB offshore market, particularly the Hong Kong market.