Optimizing Liquidity Management in China  
Ernest Mak, Bank of America - Feb 15, 2006

Companies operating in China need to fully understand the national regulatory framework to evaluate what options will work for their organization and help them maximize usage of their excess liquidity. As inter-company lending is still prohibited, corporates need to be aware of alternative cash management methods, such as leading and lagging techniques, and using a bilateral entrustment loan structure.

Contrary to popular belief, there are liquidity management tools available to companies operating in China that reduce the feeling of 'trapped cash'. However, these same companies need to fully understand the national regulatory framework to fully evaluate what options might work for their organization that will help them maximize usage of their excess liquidity.

China has traditionally had a highly regulated financial and foreign exchange regime and as a result, standard liquidity management structures available in developed financial markets such as in the US are not available. For example, Article 61 of the People’s Republic of China Lending General Principles prohibits direct inter-company lending, a common treasury technique in most developed markets. Direct funds movement from one legal entity to another is not allowed unless it is a trade related transaction, payment of service or royalty fee.

Aided by developments in China’s regulatory framework that have provided companies greater flexibility in managing their liquidity, Bank of America has worked closely with China regulators to replicate well-established foreign liquidity management solutions and offer these solutions in China while still abiding by regulatory restrictions.

Cash Centralization and Liquidity Management
There are three approaches to optimizing liquidity management in China within the regulatory framework.

The first approach employs transfer pricing as a business related tool to optimize the level of funds in the country. A trading company is established in China that purchases product from related companies overseas. This allows money to be remitted out of the country under a trade transaction rather than as a financing arrangement and does not require regulatory approval. As long as the transfer price is set at arm’s length, the tax authorities generally do not pay undue attention. Where feasible, the trading company should be established in a special economic zone where tax incentives such as reduced custom duties and taxes on imported goods may apply.

Another business related tool is structuring operations in China as a participant in a larger global trade structure. By using leading and lagging techniques, the practice of paying cash-poor entities early and cash-rich entities later, respectively, intercompany trade with other related companies around the world would facilitate funds transfer to other countries. For example, a Chinese entity would send or receive payment as an inter-company trade-backed transaction to or from related entities residing in less regulated jurisdictions. Through leading and lagging these payments, the Chinese entity can achieve a nominal level of funds.
sufficient for its daily working capital requirements without retaining unnecessary trapped liquidity in the
country.

The third approach involves optimizing domestic liquidity by leveraging an entrustment loan framework and
making use of applicable domestic investment opportunities to maximize investment yield on surplus
balances in-country.

Under a bilateral entrustment RMB loan structure, Bank of America acts as an intermediary between the
lending/borrowing parties in order to meet regulatory restrictions on intercompany lending. Under the
framework, companies have efficient use of internally generated cash and can use cash-rich entities to fund
cash-poor ones, thereby reducing overall funding costs for the group.

The structure simply involves the entity with excess cash placing the surplus funds as a deposit with the
bank, and requesting the bank to lend the funds to a designated company. The entity placing the deposit
specifies the terms of the entrusted loan, such as the borrower, purpose of the loan, loan amount, tenor and
interest rate (this is set using arm's length principles). Banks do not assume any of the borrower's credit risk
and act only as an intermediary to facilitate the structure.

To better improve the group's overall use of funds among multiple entities, various other comprehensive
liquidity management solutions based on the RMB entrustment loan framework have also been developed.

The RMB bilateral entrusted loan solution can be expanded to include multiple entities. The multilateral
entrust loan allows a company with multiple entities to benefit from simplified documentation and aims to
cover multiple entrusted loans under a single legal agreement with all individual transactions separately
initiated via drawdown notices sent to the bank. This serves to reduce the overall administrative costs
incurred if multiple legal agreements were created for separate entrusted loan transactions between group
members.

RMB daily cash concentration (otherwise known as zero balance sweeping or target balance sweeping)
solutions can also be structured under the entrusted loan framework. The balances (both positive and
negative) of several participating accounts are physically swept to a header account (which is also an active
operating account) and all participating accounts are either funded or swept to bring the balance back to a
predetermined level. An overdraft facility is granted to the header and child accounts to cater for any
overnight cash deficit position or intraday exposure. Notwithstanding the current geographic restrictions on
foreign banks providing RMB services across China, some foreign banks, including Bank of America, are
able to offer a pan-China daily cash concentration solution by partnering with local banks. These local banks
provide RMB daily cash concentration in specific cities, which have not yet opened up to foreign banks. With
this arrangement in place, funds are moved between the respective header accounts of both the foreign
bank and local bank to fund respective shortfall positions. It should be noted that in any entrustment loan
arrangement, the interest earned is subject to business tax and the loan amount is also subject to stamp
duty. Notwithstanding the tax and duty charges, this is still seen by corporates as a beneficial arrangement
since there is an overall reduction in funding costs.

Regulation governing the establishment of China holding companies dictates that holding companies
meeting certain criteria are able to establish a group finance company that is authorized to provide a range
of financial services (including local currency loans) to entities within the holding company's group. This
effectively allows the group finance company to manage domestic cash pools between multiple related
entities. The requirements to establish a group finance company are high and as such, not many
multinational companies operating in China have used the group finance company structure thus far.

Regulations allowing multi-party RMB notional pooling are currently not in place for the following reasons:

- A notional pool could be perceived as an attempt to circumvent the prevailing regulated
  interest rate environment.

- Legal protection/enforceability of cross-entity guarantees is still uncertain in the Chinese legal
  system.

- Banks have a regulatory obligation to set aside a capital reserve for overall deposit and loan
  amounts. Under current regulations, it is unclear whether deposits and loans (overdraft) from
  related entities in a notional pool may be netted in such a manner that the required capital
  reserve is for the netted position rather than the sum total.

On the foreign currency side, regulation has been passed that allows subsidiaries of selected foreign
multinationals (must have either a China holding company or a regional headquarters in China) that meet
certain criteria to temporarily lend excess foreign currency funds (up to a maximum of two years) to related
group entities domestically within China or overseas prior to formal declaration and payment of dividends.
For domestic borrowing and lending of foreign currency, the transaction may similarly be arranged through an entrustment loan agreement with a China based bank or a China registered group financial company (under a China holding company) acting as agent. Regulator approval is not required and both borrowing and lending subsidiaries must have injected their registered capital in full as scheduled before they can tap into this.

Cross-border borrowing and lending of foreign currency is structured as direct lending and regulator (State Administration of Foreign Exchange, SAFE) pre-approval is required for every transaction. There must be at least three or more domestic subsidiaries for the foreign multinational in China and the domestic subsidiary acting as the lender in the transaction must also have injected its registered capital in full as scheduled.

In October 2005, the SAFE together with the Shanghai Pudong City government passed guidelines on a pilot program to relax foreign currency restrictions for select multinational companies with regional headquarters domiciled in Pudong district. The new pilot program aims to reform foreign currency control regulations for both foreign and Chinese multinationals to effectively manage their international corporate treasury functions in China. This pilot program provides the ability to do foreign currency daily cash concentration among subsidiaries of the multinational company in China. SAFE approval is required and special accounts must be opened to facilitate the sweeping. Surplus RMB balances may also be converted to foreign currency and the resultant foreign currency proceeds extended via a cross border foreign currency entrustment loan to related offshore company to meet their funding requirements. Again, SAFE approval is required. We believe that the regulators will extend the above pilot program to more cities within the next 12 months.

**Yield Enhancements**

There are presently limited options available for RMB liquidity investment. A company’s internal investment policy and risk guidelines will have a significant impact on what types of investments a multinational may invest in. Multinationals mainly invest surplus RMB balances in call and time deposits (with regulated credit interest rates). Some choose to invest in a RMB money market or bond fund. It is still rare for multinational companies to invest in corporate bonds as they may not hold the risk rating required under their corporate investment policies.

Some banks, including Bank of America, can structure third-party entrustment loans that essentially lend surplus cash to an unrelated company. The bank provides a bank guarantee so the lender takes on bank risk rather than corporate risk. This structure allows for enhanced yields since the interest rate for the loan is higher than the regulated interest rate for balances in bank accounts. There is also an appropriate investment risk profile since the lender would more than likely require the intermediary bank to be on sound financial standing.

Foreign currency balances may be placed in time deposits to generate higher yields than earned in a demand account. Companies are unlikely to hold significant foreign currency balances given existing regulation that imposes a set limit on foreign currency account balances mandating any excess over a pre-set limit be converted to RMB within a 90-day timeframe.

**Funds Repatriation**

Multinational companies can repatriate surplus funds out of China through:

- Dividend payments
- Payment of management service or royalty fees
- The cross-border foreign currency entrustment loan solution
- Leading and lagging solution and use of transfer pricing

Some international banks have structured cash deposit pledge arrangements whereby an offshore loan is granted by a bank in a foreign currency to a related entity with the RMB balances pledged to the bank’s branch in China as security. In addition, some international banks have put in place a virtual pool structure where the balances remaining in China are offset against other foreign currency balances in other countries to optimize regional credit interest. However all these kinds of structures do not truly reduce surplus balances in China but rather simply optimize the benefit to the wider group of offshore related companies from the need to have balances remaining in China.

**Summary**

The China banking landscape will continue to rapidly evolve through time. What was previously considered not permitted for liquidity management is now possible. In such a dynamic and evolving environment, it is of
critical importance to stay close to banking partners who not only have access to the latest developments from the regulators but are also committed to the cash management business. Banks such as Bank of America are constantly developing innovative liquidity management and investment products in close consultation with financial regulators and multinational clients who are building their presence in China.

Note: This article contains suggestions only, and is not meant to substitute for your own internal procedures which are appropriate for your company. This information is not legal or tax advice. You may wish to consult your own legal and/or tax advisors to discuss your company's needs.