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Accessing the CNH Market for Cost-effective Working Capital

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While the evolution of the Chinese yuan (CNY) trade settlement scheme has attracted much attention, recent developments in the offshore CNY bond market in Hong Kong have opened up an alternative funding channel for foreign corporations wishing to do business on the Mainland. This article examines these developments and outlines the new opportunities they present for cross-border trade settlement.

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Regulatory Changes

Two regulatory events in 2010 are already looking like watershed moments for both Hong Kong markets and the internationalisation of the CNY. In February, the Elucidation of Supervisory Principles and Operational Arrangementsagreed between the People's Bank of China (PBOC) and the Hong Kong Monetary Authority (HKMA) significantly widened the range of entities permitted to issue CNH (the abbreviation now typically used for CNY deliverable in Hong Kong) bonds in Hong Kong. Previously, only highly-rated Chinese banks had issued in this market, but from February 2010 a wide range of entities outside China were alsoallowed to issue CNH-denominated bonds in Hong Kong.

The elucidation was followed in July 2010 by the joint signature of a Supplementary Memorandum of Co-operation by the HKMA and PBOC. In effect, this created a comparatively relaxed regime for CNH trading in Hong Kong by expanding the range of eligible holders. This change is already reflected in the sharp increase in CNH market liquidity; as of January 2010 there were CNH64bn in deposits in the Hong Kong market – by November this had reached CN H279bn. Over the same period, the number of financial institutions authorised to offer CNH products had also risen sharply – from 65 to 98.

Impressive as this growth is, current CNH deposits are still about 3% of all deposits in Hong Kong. Conservative estimates anticipate that by the end of 2015 close to a third of deposits in Hong Kong will be CNH-denominated. Apart from the common expectation of future CNY/CNH appreciation, a further factor is that the pricing of items ranging from property to food to water supplies is increasingly being driven by the influence of CNY, though still nominally priced in HKD.

Dim Sum Bonds and Certificates of Deposit

The growth in CNH deposits continues to underpin parallel growth in the issuance of dim sum bonds (CNH bonds issued in Hong Kong) and certificates of deposit (CDs). The CNH bond market in Hong Kong got underway in 2007 (the CD market followed in 2010) when the available deposit base was deemed high enough and the Chinese government allowed a few select Chinese banks (such as China Construction Bank and China Development Bank) to issue CNH bonds in Hong Kong. The market remained much the same until 2009 with issuers being predominantly large Chinese banks, although in 2009 the Chinese Ministry of Finance also participated for the first time.

After steady issuance growth between 2007 and 2009, (CNH10bn in 2007, CNH12bn in 2008, CNH16bn in 2009) the pace picked up sharply in 2010 to around CNH40bn of CNH-denominated bonds and CDs. Even allowing for the CNH deposit base, there still remains a major supply/demand imbalance, so given the relaxed issuance environment it seems perfectly feasible that issuance may increase substantially, or even double, in 2011. This compares favourably with the larger HKD-denominated market, which over the past five years has seen issuance range betweenHKD90bn and HK D180bn, with issuance in 2010 of around HKD135bn.

Growth Factors

Given the growth rate of CNH issuance, it looks likely that it will surpass its HKD counterpart at some point in the next two or three years. In part this is due to the different appeal of the two markets. The HKD bond market is essentially domestic; since the currency is pegged to the US dollar (USD), overseas investors can simply access the USD bond market instead. By contrast, the CNH bond market is global; apart from the range of issuers, the appetite for CNH-denominated investment instruments is intense in view of the currency's likely appreciation. In effect, where issuance is from highly rated borrowers and the credit risk is minimal, shorter dated two and three year bonds are commonly seen as primarily a currency play.

The global nature of the CNH bond market is facilitating its rapid growth. Typically, a new bond market would initially consist of issues from the highest rated borrowers that would build the foundations for several years before other credits started to issue. However, this process has been accelerated in the CNH bond market, with quasi high-yield issuers such as Galaxy coming to the market hot on the heels of McDonald's and Caterpillar. The global appeal of CNH bonds means that the market can access a broad spectrum of investors, ranging all the way from those only interested in the highest grade sovereign debt, to high yield specialists.

Apart from sheer demand, other factors are likely to drive further issuance of CNH-denominated bonds. One consideration from the issuer side is convenience/cost; until September 2010 CNH bonds were issued using stand-alone documentation specifically for the purposes of the Hong Kong market. However, in September McDonald's made a CNH200m three-year issue as part of its existing medium term note (MTN) programme – and was followed in November by Caterpillar using the same mechanism with a two-year CNH1bn issue.

Issuers – especially at the higher yield end of the credit spectrum – are also likely to be attracted by the potential interest cost savings available from issuing CNH-denominated bonds. With demand for CNH bonds so strong, high-yield issuers that might have to pay an 8-9% coupon in the USD market might currently be able to issue at sub 5% in CNH.

Finally, certain recent issuance has started to create something of a virtuous liquidity circle through the development of a CNH yield curve. One commonly cited example of this was the Asian Development Bank's CNH1.2bn issue in October 2010. As Peter Pang, Deputy Chief Executive of the HKMA remarked at the time, the issue was significant in that it extended the universe of issuers to include AAA-rated international financial institutions, but also because it marked: "…a significant extension of the tenor of renminbi bonds from two, three and five years to 10 years. This will no doubt help the development of a benchmark yield curve for offshore renminbi bonds over time."

Right Currency, Right Place

Given that the CNY is widely expected to strengthen, the ideal scenario is for the issuer of a CNH bond to have a CNY income stream with which to fund interest payments and repayment of principal. (Issuing in CNH and then swapping into USD is currently expensive for most investment grade issuers.)

This raises two questions:

- What is the mechanism for moving CNY raised from a CNH bond issue in Hong Kong to the Mainland where it can be used to generate a CNY income stream?
- Is it more effective to issue a CNY bond on the Mainland instead?

The answer to the first question largely depends upon who you are. The process by which this is accomplished is well defined, but differing rules apply to corporations and financial institutions (FIs). Apart from the cross-border trade settlement programme, the two key routes for remitting funds to the Mainland are by capital injection or foreign debt. The former requires approval from the Chinese Ministry of Commerce and is available to both corporationsand FIs. The latter is based upon different mechanisms: 'borrowing gap' in the case of corporations and 'foreign debt quota' in the case of FIs. The basic principle – the foreign debt of onshore entities – is the same in both cases but the calculation methods differ. (The foreign debt route is not available to real estate companies and has no precedent for auto financing companies.)

Once cash has been raised via an offshore CNH bond issue, the borrower can then remit the CNH proceeds to onshore China via the various channels that it has already got approvals from the Chinese regulators for. If the issuer is in no rush to remit the CNH proceeds into China, then there are a variety of cash management options.

Obviously the length of time the proceeds are likely to be in Hong Kong prior to remitting to China will affect the choice of deposit instruments. The Standard Chartered Bank current/savings deposit board rate as of December 2010 was 0.45% per annum, but term deposits that offer a higher interest rate are also available. CNH funds in Hong Kong can also be invested in any other available CNH-denominated investment products available there, such as CDs or bond funds.

The answer to the second question is that issuing bonds directly on the Mainland is a possibility for the future, but there are various issues that would have to be overcome in doing so. From an international perspective, market standards differ from those used internationally. Borrowers would also be unable to leverage their existing MTN programmes when issuing there and would need new dedicated professional advisers. In addition to Chinese language documentation, issuers need to procure ratings from local rating agencies and would also require individual regulatory approval for each issue. By contrast, specific approval is not required in Hong Kong; the market already adheres to international standards and time to issuance is appreciably shorter.

Another consideration is that some onshore subsidiaries might be too small to issue bonds there on their own credit. In addition, with strong demand in the Hong Kong market, issuing there in a parent name via a five year or longer dated bond and then using either the capital injection or foreign debt method to move funds onto the Mainland to a subsidiary may not only be more cost effective, it may also reduce refinancing risk. In view of the tightening interest rate cycle onshore this compares favourably with alternatives such as having to annually renew one year bank facilities.

However, despite the hurdles for overseas entities issuing onshore, the sheer size of the market may nevertheless make it worthwhile for subsidiaries of international companies to consider issuing there in the future.

Open for Business

Apart from a benign regulatory environment and rapidly deepening liquidity, the Hong Kong market also already has the necessary infrastructure in place to facilitate CNH-denominated business:

- The HKMA's Central Moneymarkets Unit (CMU) has been able to handle the clearing and settlement of CNH-denominated bonds since March 2006.
- Hong Kong Interbank Clearing Limited (HKICL) already offers the following CNH Interbank funds transfer capabilities:
  - CNH local cheque clearing and settlement;
  - CNH cross-border joint cheque clearing;
  - Delivery versus payment for CNH-denominated bonds through a linkage with the CMU;
  - Automated remittance of CNH funds relating to issuance of CNH bonds; and
  - Electronic clearing and settlement of CNH Central Clearing and Settlement System (CCASS) and CNH Investor Account Holder (IAH) items, i.e. money settlement instructions related to CNH CCASS and CNH IAH participants.
- Hong Kong Exchanges and Clearing Limited (HKEx) is capable of trading and clearing CNH-based products.
- Authorised banks are able to offer credit lines to support clients' CNH needs.
- Testing sessions for readiness in trading CNH-denominated instruments were held between the HKEx and clearing members starting from 10 September 2010.
- Euroclear Bank is able to settle CNH-denominated securities.
- HKEx accepts CNH as cash collateral for margin requirements.

An Opportunity – But

The regulatory changes in the Hong Kong market during 2010 represent a major opportunity for foreign corporations looking to do business with China. Suitable entities can access highly competitive CNH funding for trade-related activities while simultaneously minimising their foreign exchange (FX) risks.

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However, there are some caveats. As mentioned earlier, the CNH bond market in Hong Kong is global in its appeal. Therefore, making the most of the funding opportunity requires a banking partner with an unusual combination of abilities. On the one hand, a global distribution network for bond issuance is essential, but so is in-depth local expertise and distribution at both retail and institutional levels.

In addition, any such partner needs to be able to provide support in the secondary market by supporting competitive two-way pricing for both the bonds in question and associated instruments. To deliver the complete financing solution, it must also be able to offer expert assistance with the matter of moving the bond issue's proceeds to the Mainland in a timely manner. That not only requires a deep understanding of onshore regulation, but also expertise in the nuances of how that regulation is actually applied in the various Mainland provinces.

Conclusion

While the complete internationalisation of the CNY may still be some way in the future, recent events suggest that the pace is increasing. The deregulation of the offshore market in Hong Kong has opened a new capital channel for foreign corporations that will facilitate their activities on or with the Mainland. The evolution of the CNH market is obviously significant in its own right, but at present its most important aspect is that it provides support for cross-border trade settlement business.

As the overall CNH environment continues to improve, its support for trade settlement will become even more extensive. Underlying deposit liquidity is already growing rapidly, driven by both existing retail and tourist activity and also increasingly by new trade-related flows. Liquidity is also improving in other associated instruments such as deliverable forwards and spot. In brief, many of the essential components for accessing cost-effective CNH working capital are already in place. The key remaining questions for foreign corporations remain how best to accomplish that – and with whose assistance?

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