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Measuring Value®
RMB: Cash flowing and cash trapped

Since reforms began, China's leaders and regulators have been particularly attentive to matters around the currency and cash movements across borders. Foreigners who visited China in the early years of reform will remember the Foreign Exchange Certificates (FEC), an entirely separate currency created for the use of foreigners while inside China, intended to keep even casual visitors from trafficking in the real currency.

While the FEC is long gone, some of the basic principles governing foreign investment in China and the regulation of funds invested or earned here have endured relatively unchanged. China's analysis of the triggers for the Asian Financial Crisis of 1997-98 strengthened the resolve of Chinese regulators to maintain careful control over cross-border currency flows.

As a result of the interlocked regulations governing currency exchange, cash repatriation, domestic lending regulations, and domestic investment regulations, many MNCs are sitting with trapped cash, money they can neither move out of China nor reinvest with much freedom or efficiency inside China. As their business and cash flow have increased, these sums have often increased proportionately, representing a major headache in both managing cash efficiently and evaluating Chinese business performance.

Given the global credit situation and the extreme pressure to improve liquidity in virtually every major MNC, it is a good time to review the issue of cash management in China and consider some of the potential prospects for change

This issue of Measuring Value is not intended to be a thorough technical review of the ins and outs of trapped cash but an overview of some of the key strategic and tactical approaches to minimising the trapped cash risks for executives with P&L responsibility.

Sources of money difficult to repatriate
How does cash get trapped?

For the unwary foreign investor, cash can get trapped as a result of the way initial capitalisation of an enterprise is structured and as a result of profits generated from successful operations, or simply fees charged or loans extended by overseas companies that cannot be remitted due to government rules and regulations

The cash contribution made by a foreign investor with funds originating outside China to meet the registered capital requirements of a licensed enterprise, either WOFE or JV, is capital account money and very difficult to repatriate should the equity stake be restructured, liquidated, or sold. This is often the major source of large amounts of trapped cash, but it is not the only source. Other early stage in-bound cash flows, including advance payments remitted to an on-shore subsidiary of an off-shore company that cannot be counted as capital also will likely fall under capital account controls.

Basically, the only straightforward way to repatriate capital contributions is formally to reduce an entity's registered capital, a difficult undertaking

For returns generated by an operating entity in China, dividends are the primary, straightforward ways of repatriating cash. But a cluster of limitations on dividend repatriation also creates a major source of trapped cash. Dividends can be converted and repatriated based on after-tax earnings, minus a number of mandated reserves, including a statutory 10 percent enterprise reserves, up to 50 percent of registered capital, against potential losses, and reserves for employee welfare (sometimes optional). These reserve funds cannot be repatriated even if an enterprise has no losses or likely prospect of losses or for some other reason are not actually needed for their prescribed purpose. From enterprise earnings, additional trapped cash can be generated via related party expense allocations and depreciation. Enterprises with large fixed asset bases generating significant depreciation deductions save the money from the tax collector but cannot take it out of the country as after-tax profits, potentially creating a trapped cash pool as large as the depreciation value over the life of their fixed asset investment.

Dealing with the issue

To a large extent, means of unlocking trapped cash in China depends on the origins of the trapped cash.

There are basically three strategic imperatives in minimising the trapped cash problem

First and foremost, foreign investors should avoid putting any more capital at risk through early and informed planning for any registered capital requirements or anticipated operating cash requirements prior to an enterprise generating sufficient cash flow to be self-sustaining, and this often means savvy use of debt, while meeting China's specific debt-equity requirements for the total investment level and industry.

Secondly, structural and service arrangements should be carefully planned to support the movement of as much cash as possible under rules governing current account transactions as opposed to capital account transactions, and this often means contractual arrangements between a China subsidiary and off-shore affiliates as parents for goods, intangible property, and/or services that permit cash flows in either directions under current account rules.

Thirdly, while there are arguments for setting up a number of specialised entities for foreign investors that are engaged in manufacturing, services, and R&D in China, generally from a cash management standpoint, it is preferable to minimise the number of separately licensed entities and use branch structures. To do this successfully a WOFE or JV's original scope of business needs to be articulated very carefully, so future business activity at headquarters and at branches can legitimately fall under authorised scope without the expense and risk of restructuring the operation or setting up a new entity. But even a branch application will invite a review of operating capital sources and adequacy. For major investors in China, an international holding company or a regional headquarters offers the opportunity to move funds among invested entities and to establish an internal finance company to operate such transfers. But such movements are subject to a number of SAFE regulations and approvals, may trigger a review by CBRC and they may be inefficient from a tax perspective.

To avoid unnecessary cash traps related to registered capital in the early stages of a new enterprise or during restructuring, the major key is optimal use of debt, both off-shore debt originating in foreign currency and on-shore debt in RMB

Recently, regulatory changes and market conditions have made on-shore RMB debt more available for operating capital and most recently for asset investment than in the past. This is often underutilised by foreign investors.

If an investor has accumulated RMB funds in one business and wishes to use them for capital or operating needs in another, a licensed bank can implement an entrustment loan for a nominal fee, an efficient way to use RMB funds trapped in China and avoid trapping additional cash. The Group Entrustment Loan is a variation offered by some foreign banks operating in China that permits flexible movement of cash among a group of related companies legally and efficiently. These services can be quite advanced, including China-wide daily cash-sweeping across a number of entities to maintain optimal preset balances in each individual enterprise, managed investments for best available yields, and optimised current account settlement services.

The limitations on repatriating after-tax profits, plus the addition of a withholding tax on such dividend distributions that began in 2008, has made certain current account transactions a very attractive alternative to dividend repatriation. These include loan repayments, royalty payments to a related party, service fees, and importation of goods with reasonable margins from a related party. They include selling of equity from one FIE to another and outbound investment from one FIE to an off-shore entity, but there are potentially adverse tax impacts from such transactions. Trade activities between related parties are subject to increasingly tough transfer pricing scrutiny, but at the same time payment timing, including advance and lagging payments for goods and services can add efficiency to cash management. A review of supply chain and business models may add tax benefits and improve cash movement within affiliated group. In addition, a good health check of treasury functions and cash management should consider such alternatives, with benefits weighed against potential tax inefficiencies.

In June 2009 SAFE significantly expanded previously restricted regulations that permitted certain loans from on-shore enterprises to off-shore subsidiaries and investees. The June changes opened the possibility for any on-shore company to do this directly, avoiding an intermediary entrustment agent, but with specific technical limitations. The full impact of these changes has not been assessed, but creative use of these new investment channels may provide an important option for reducing trapped cash.

Transmittal of cash out of China under current account rules has been simplified over recent years, but documentation has to be appropriate and convincing. That is particularly compelling at the moment, as tax and customs authorities appear to be stepping up compliance monitoring and non-compliance costs sharply.

Putting trapped cash to work

As a last resort and depending on expectations of RMB values, if on-shore funds cannot be legally repatriated to an off-shore parent, it is important to explore potential uses for the funds other than depositing them in low-yielding Chinese bank accounts

Given the development stage of China's financial services and the very tight administrative control of banking activities, current investment options for RMB cash trapped in China are limited. Call deposits and time deposits at statutory interests rates are the safest options and the lowest yielding. Some new money markets options and bond funds are becoming available, but China's corporate bond market offers little that would meet the risk requirements of most MNC investment guidelines.

Bilateral entrustment loans facilitated as described above allow cash-rich JVs and WOFEs to lend money to unrelated third parties through an intermediary. These loans can be established in RMB or foreign currency. If MNCs expect further appreciation of the RMB or additional RMB capital investment demands on-shore in China, entrustment loans to a third party are a way of putting the money to good use while awaiting other investment needs. Interest rates can be freely set by the engaged parties (although most banks set a ceiling of 400 percent of the standard PBOC rate),but the bank serving as the entrustment agent does not assume the credit risk in such transactions. Banks offering entrustment services can also arrange for guarantee banks to insure the risk.

Under pressure to continue financial system reform to meet the needs of China's growing global role, regulators are simultaneously making adjustments across a range of related areas, including such things as loans between unrelated parties, leasing and lease-like financing arrangements, access to RMB funds for private equity investment on-shore, use of trade settlement off-shore in RMB, and simplification of outbound lending and investment procedures. In August, State Council and NDRC measures were vetted that would expand the legal basis for global private equity investors to raise RMB funds in China if and when enacted.

It is often in the intersection of these diverse control regimens that knowledgeable and agile foreign investors can find excellent solutions to issues like trapped cash

Conclusion

The global financial crisis is reshaping the world's financial systems, and it is creating pressures on China's traditional financial regulations and practices. While China's principled commitment to tight capital account controls shows no sign of abating, the urgency of domestic liquidity management and facilitating outbound investment for Chinese State-owned and private national champion companies is one of many factors forcing a stream of reforms governing cross-border transactions. MNCs active in China are advised to be very diligent in health-checking their current treasury activities and in staying abreast of changing regulations and best practices.

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Outbound investment

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