

Presented at the Member Update:  
RMB Financial Products in Hong Kong  
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Lifting the Dim Sum lid  
*RMB products at a glance*

April 2011

RMB, CNY, CNH. Panda bonds, dim sum bonds, synthetic bonds. Loans, funds, derivatives, IPOs. What do they have in common? They are all terms relating to the fast-developing Renminbi market in Hong Kong. They are central to the discussions of bankers, lawyers and CFOs. Some of the jargon remains confusing, the difference between some of them unclear. This paper distils Allen & Overy's insight and transactional experience concerning Renminbi in each of these products areas, bringing you the latest market information and addressing your key concerns.

## Where is RMB available offshore?

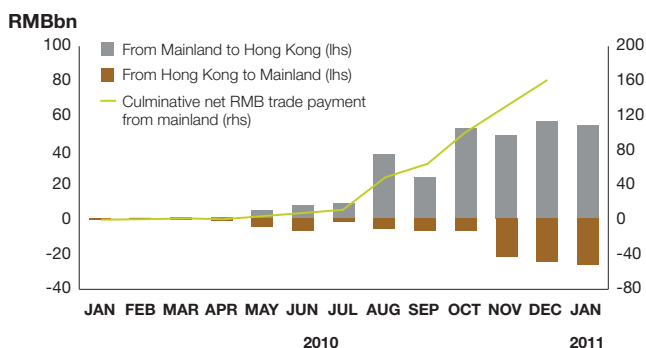
Hong Kong has the largest pool of RMB outside mainland China thanks to an official arrangement with the PRC government. RMB is largely "convertible and transferable" in Hong Kong. Other jurisdictions may also accumulate RMB, but only through cross-border RMB trade settlement and only if used for such purposes. Due to a lack of official arrangement (especially in respect of RMB clearing), the development of RMB products in other jurisdictions remains slow.

## RMB, CNY, CNH – what's the difference?

Renminbi, or RMB, is the official name of the currency of China. CNY refers to RMB onshore mainland China ("yuan" is the official unit of RMB hence the "Y"). CNH refers to RMB offshore mainland China (mostly in Hong Kong hence the "H"). Due to the effective segregation of the onshore/offshore RMB markets, CNY and CNH are subject to very different demand and supply forces which result in different yield curves. CNH is virtually treated as a different currency.

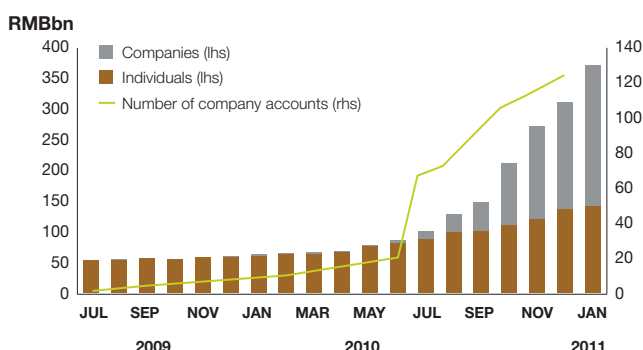
## Growth of RMB business

RMB TRADE SETTLEMENT CONDUCTED THROUGH HONG KONG



Source: HKMA

RMB DEPOSITS IN HONG KONG



Source: HKMA

## Panda bonds, dim sum bonds, synthetic bonds

ISSUER	TARGET MARKET	KEY ATTRACTION
Panda – certain offshore entities	Mainland interbank market	Proceeds directly available for onshore use, large domestic investor base
Dim Sum – mainland commercial banks	Hong Kong	Settled legal regime, mandatory repatriation of proceeds
Dim Sum – any offshore entity	Hong Kong	No mainland regulatory control for issuance
Synthetic – any offshore entity	Anywhere	No mainland regulatory control for issuance, no need to source RMB funding to repay

Despite the hype, dim sum bonds are not the only option to raise RMB funding in the capital markets. Issuing panda bonds or even using an onshore subsidiary to issue directly onshore would ensure that funds are available onshore without the uncertainty of repatriation. Synthetic RMB bonds spare you the worry of sourcing RMB for repayment whilst providing the investors with the same exposure to the currency. There are also regulatory arbitrage opportunities for repatriation between different types of bonds, especially for some of the “sensitive” industry sectors such as real estate. Even for dim sum bonds, repatriation by

way of equity injection or inter-company loans may not be the only means of utilising RMB proceeds. Some issuers have managed to consume the proceeds either offshore or through cross-border current account payments.

Consider all options – very different solutions are available in terms of timing, funding costs, investor base, profile and documentation. Sourcing of RMB funding for repayment and RMB cashflow to service the coupon continue to be the two issues at the forefront of issuers’ minds.

## Dim sum bonds

### *Why are they attractive?*

#### INVESTOR'S PERSPECTIVE

- Lack of other investment channels for offshore RMB

#### ISSUER'S PERSPECTIVE

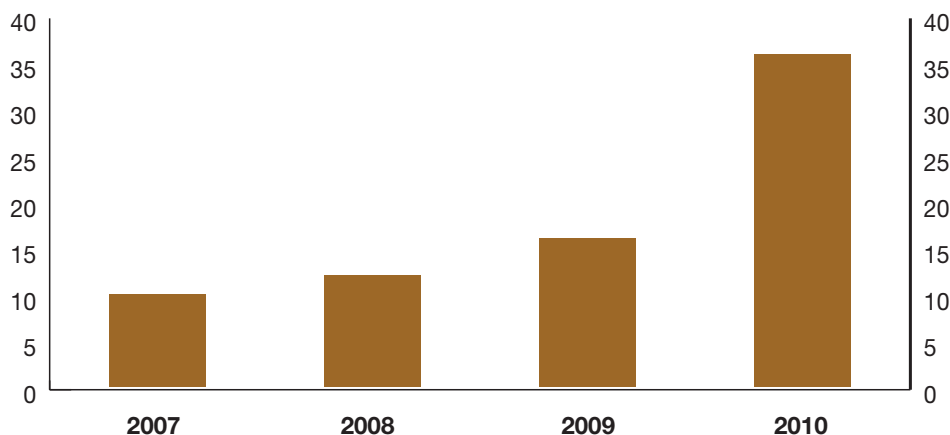
- Cheaper than funding RMB onshore
- Easier than funding RMB onshore or cross-border
- No regulatory approvals required from mainland China, Hong Kong or elsewhere, if sold to professionals
- Look and feel of Eurobonds as they are documented and sold much like Eurobonds
- Ability to better match RMB assets and liabilities
- Successful precedents by non-PRC corporates such as McDonalds, Caterpillar, Galaxy, Orix, Unilever.

### *What to watch out for?*

- Managing the regulatory risk in respect of repatriation remains the greatest area of uncertainty in terms of success and timing. Applicable regulatory approvals are discretionary and ad hoc, largely depending on your industry, company profile and intended use of proceeds. The interaction of the regulators in charge (such as PBOC, Ministry of Commerce and the State Administration of Foreign Exchange) is sometimes unclear. Having the right partner as underwriter or external counsel with appropriate regulatory resources is a key factor to consider.
- Documentation could be structured as a take-down off an existing programme or a standalone issue. In both cases, disclosure on local settlement and clearing (in the CMU service) and currency and China related risks should be included. Illiquidity concerns for corporates which are not active in the RMB market can be addressed in payment terms as well as risk disclosure.

#### RMB BOND ISSUANCE IN HONG KONG

### RMBbn



Source: HKMA



## Loans

Chinese regulations do not restrict how offshore banks can deploy the increasing amount of CNH deposits – including lending – so long as their uses remain outside of China. Under Hong Kong regulations, banks are not allowed to lend CNH to individuals and certain limited types of corporate but could otherwise lend CNH freely, by and large. Security over CNH deposits and CNH bonds offshore can also be taken with ease and in the same way as deposits and bonds in other euro currencies. Security structures involving RMB in onshore non-resident accounts (NRAs) are also seen.

However, the CNH loans market is lagging behind the bonds market somewhat. Only one syndicated CNH loan facility – a multi-currency facility including a CNH option that closed in December 2010 – has been reported to date. Why?

In addition to the repatriation issue similar to that for dim sum bonds, there is also currently no real interbank market for CNH; liquidity is very much concentrated within the deposit takers. There is a general view that establishing a CNH reference rate (eg a HIBOR CNH rate) would facilitate the growth of floating rate lending and an interbank market, but there are challenges in establishing a reference rate.

Lenders will need to be comfortable with how borrowers will source CNH to service their debt.

Furthermore, as is the case for bonds, the market is considering whether or not to legislate for a fall-back position if CNH becomes illiquid – because of a drop in cross-border trades being settled in CNH for whatever reason, or because of regulatory changes in China.

There remains a great deal of appetite in the market for CNH loans to be put together; the obstacles highlighted above will need to be resolved.

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## Funds, Structured Products and Derivatives

Currently, only RMB bond funds are available due to (i) the lack of other RMB instruments offshore and (ii) restrictions on cross-border investment in mainland RMB instruments. The latter is likely to change once “mini-QFII” starts – where Hong Kong subsidiaries of mainland securities firms and fund managers will be allowed to invest in mainland securities (stocks likely to be limited to 20%) in RMB. The first RMB fund in Hong Kong launched by Haitong Securities Hong Kong (a subsidiary of mainland Haitong Securities) was authorised in August 2010.

It does not currently have, but leaves room in the future to have, the ability to invest in mainland securities. It begs the question of what happens if such ability does not come into play during the life of the fund.

RMB structured products have been issued in Hong Kong on a private basis. HK regulators and HKEx continue to mull over the launch of retail or listed structured products – both weighing up technical readiness and

getting comfortable in addressing the RMB liquidity issue. Similar to bonds, RMB denomination dictates the inclusion of specific risk disclosure and payment mechanics in the documentation.

There is now also some appetite in derivatives over the dim sum bonds, either via total return swaps or indices (which HSBC and Citibank are setting up). In the OTC derivatives context, market participants are seeking standardisation of language on inconvertibility, non-intransferability and (the most difficult one) illiquidity as market disruption events specifically applicable to physically settled RMB transactions.

Repos over dim sum bonds are also being used to help increase intra-day liquidity.



## *IPOs*

It has been widely publicised that Cheung Kong, a major property developer in Hong Kong owned by business tycoon Li Ka-shing, plans to complete the listing of the first RMB-denominated REIT (real-estate investment trust) this April. The status of this transaction has been the subject of conflicting reports, including reports that the scheduled launch has been delayed amidst concerns over RMB liquidity amongst other issues. The Hong Kong Stock Exchange is exploring the feasibility of a RMB liquidity pool where banks, brokers and underwriters will work together to provide RMB on a limited basis to investors who would be able to trade in and out of RMB shares in Hong Kong Dollars.

As REITs are closed-ended funds, redemption is not a concern. For this and other reasons, immediate repatriation into and timely repayment of proceeds out of mainland China is not as pressing an issue as for the RMB bond issuers. Cross-border payment of dividends in RMB is already feasible which would create the cashflow for paying distributions to investors. However, it remains to be seen how the large amount of RMB proceeds raised from the IPO could be best put to use.

It is also likely that the RMB or China related risk disclosure statements in other RMB products will find their way into the documentation in appropriately modified fashion.

The initial REIT deals are expected to pave the way for general RMB denominated equities issuance in relatively short order.

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## *What's next in RMB internationalisation?*

### **Overall policy backdrop**

Understanding the Chinese authorities' overall policy on RMB internationalisation, it is necessary to understand:

- the existing liberalisation and constraints of the offshore RMB market;
- what to anticipate next; and
- what you can do to lead the market.

The leading Chinese authority, the People's Bank of China – the No. 2 Currency Policy Department, was set-up specifically for this purpose and supported by the State Council to lead the RMB internationalisation initiative.


### *Stages of RMB internationalisation*

- Current account items (such as cross-border trade) before capital account items (such as investment).
- RMB outflow before RMB inflow in respect of capital account items.
- Increasing both width and depth of the offshore RMB pool before allowing the free flow of RMB cross-border.

The key principle: to develop an international currency that is supported by real economy and to avoid currency speculation.

*This would explain why, for example:*

- you should keep an open dialogue with PBOC (whenever possible) – something that we do at A&O;
- there is continuing control over cross-border movement of RMB for capital account items, which results in effective segregation of the onshore/offshore RMB market, which in turn means the supply of RMB offshore is not in all cases infinite, that is why liquidity of RMB offshore remains the key issue behind all offshore RMB products requiring the actual delivery of RMB;
- any cross-border RMB payment in respect of capital account items at this stage is in support of the current account items and therefore unlikely to be unconditional (for example, allowing cross-border investment on the mainland interbank market provides investment channels for RMB accumulated through trade settlement);
- the clearing bank in Hong Kong may offer conversion to and from RMB on an unlimited basis for cross-border RMB trade settlement but conversion for general purposes is still subject to overall quantitative control. This, in turn, explains why there are two exchange rates for the same currency pair involving RMB;

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- the legislation on overseas direct investment in RMB (ie RMB outbound) came out earlier than that on inbound RMB direct investment; and
  - for all inbound RMB payments, use of proceeds will be a key issue for the regulators to verify to prevent any currency speculation and ensure genuine economic purpose.

Until now, conversion and availability of RMB offshore in respect of current account items (such as for international trade settlement) have been largely unrestricted. On capital account and for outbound, overseas direct investment by a PRC corporate can now be made in RMB. On capital account and have been for inbound, repatriation of RMB as loans or equity investment is allowed on a discretionary basis and cross-border investment in the RMB instruments on the mainland's interbank market is partially allowed. With the exception of RMB IPOs where The Hong Kong Stock Exchange is actively pursuing the establishment of an RMB liquidity pool, market solutions on all products are largely consensual and contractual.

We have been involved in numerous landmark transactions since the development of the offshore RMB market including, amongst others, issuances by Asian Development Bank, Caterpillar and Unilever. This snapshot will be followed by a more in-depth flyer on the different ways to raise RMB funding. For more information on RMB products and our experience across the different disciplines, please contact either the Dim Sum team at [dimsumenteam@allenoverly.com](mailto:dimsumenteam@allenoverly.com) or your usual Allen & Overy contact.

*The natural next steps would lie in the further opening of RMB capital account items such as:*

- Expansion of the panda bonds programme, which would allow the issuance of RMB bonds on China's interbank market.
- Expansion of the RMB QFII programme (including mini-QFII), which would provide more channels to invest in mainland RMB securities (on the interbank market and on the stock exchanges).
- Legislation on repatriation of RMB proceeds from dim sum bonds, which would bring certainty to the repatriation issue and remove practices unfavourable to certain industries.
- Possible legislation on foreign direct investment in RMB, which would permit equity investments in China in RMB regardless of the source of funding (ie not limited to proceeds from dim sum bonds).