Settlement Methods and Risk-hedging for Domestic Sales in China (Part 1)

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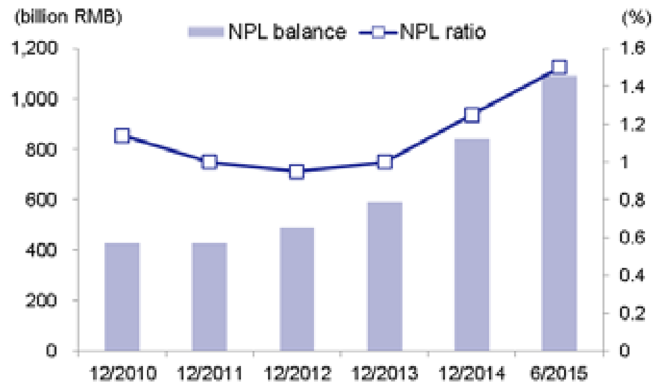
The environment surrounding Japanese companies in China has changed dramatically in recent years. Especially since more and more companies take China as a sales market, many of them are now struggling with China's unique settlement methods, as well as settlement risk triggered by China's stalling economy and intensified competition. Divided in two parts, this report will outline essential settlement methods and related risks for companies engaged in domestic sales activities within China, and examine effective risk-hedging solutions.

Changing investment environment and intensified competition

China was once regarded as a low-cost manufacturing hub for Japanese companies. Products manufactured in China were mainly sold to the Japanese parent companies or overseas group companies. When products were sold within China, sales partners were mainly limited to group companies or other foreign-invested enterprises with good creditworthiness. In cases where Japanese companies sold to local Chinese enterprises, with their strong competitiveness, backed up by the high quality of their products, they could usually pick sales methods with no repayment risk, such as advance payments.

However, in recent years, more and more Japanese companies have started direct sales to Chinese enterprises. Also, in face of intensified competition with quality-improved Chinese products and lower-price imports from Southeast Asia and so, Japanese companies are forced to choose risk-contained settlement methods such as switching to credit sales. As a result, debt recovery has become an important issue. As reported currently, commercial banks in China are facing a rise in the amount of non-performing loans (see Fig. 1). It is also necessary for companies to examine the issue of debt recovery and associated risk management when selling to Chinese enterprises.

Fig. 1: Non-performing loans of China's commercial banks, published



Source: The China Banking Regulatory Commission's 'Major Supervisory Indicators of Commercial Banking Institutions'

Settlement methods and associated risks inside China

It is important to have a clear understanding of each settlement method in order to improve recoverability when discussing risks related to payment collections from these buyers. We will first look at some common settlement methods in China.

Fig. 2 presents typical methods used in China in order of payment collection risk (default risk) as seen from the seller's side, from A to E.

Fig. 2: Settlement methods in China and location of risk

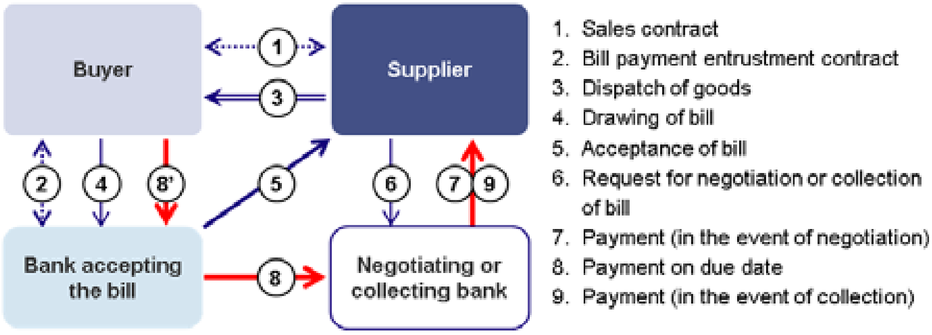
	Settlement Method	Location of Risk
A	Settlement in cash (Advanced payment; cash-on-delivery)	—
B	Banker's acceptance bills	The bank accepting the bill
C	Domestic L/Cs	The bank issuing the L/C
D	Trade acceptance bills	The party accepting the bill (usually the buyer)
E	Remittance payments with usance	The buyer

Firstly, of course, method A ,'Settlement in cash (advanced payment and cash-on-delivery) bears the lowest risk. As for method E, 'Remittance payments with usance', as it is a method of credit sales, the seller will face payment collection risk and credit risk until the seller receives the payment on the due date. As such, this is the most risky settlement method. These settlement methods are not unique to China; they are used far and wide in cross-border trade.

Next, both method B, 'Banker's acceptance bills' and method D, 'Trade acceptance bills' involve the issuance of bills of exchange that bind the buyer to pay by a specified date. They are both treated as commercial bills in China.

However, it would be fair to say that method B is comparatively safer, given that payment on the due date is guaranteed (underwritten) by a bank (see Fig. 3). In addition, though unrelated to collection risk, 'Banker's acceptance bills' are also a common tool for financing, with the bills often encashed before the maturity date through discounting.

Fig. 3: Transaction flow of 'Banker's acceptance bill'



On the other hand, with method D, 'Trade acceptance bills', the bills are not guaranteed by any bank and they involve credit risk related to the buyer, such as refusal of payment, delayed payment or dishonored bills, indicating greater collection risk.

As a result of these divergent risks, 'Banker's acceptance bills' are currently issued in higher volumes than 'Trade acceptance bills'.

Furthermore, penalties for dishonored 'Trade acceptance bills' are more lenient in China compared to Japan, which is another reason why they are not recognized as a reliable settlement method. The penalties are getting stiffer, as outlined in Fig. 4, but the current system still lacks the rigor of the Japanese bill clearance system, where penalties such as suspended banking transactions for companies who dishonor bills twice within a six-month period exist.

Fig. 4: Summary of Chinese regulations for handling dishonored bills

Imposition of fines by PBOC

Bills: 0.07% of face value per each day late

Checks: 5% of face value (minimum RMB1,000)

- ✓ When the payment deadline is missed, a fine of 3% per day is added to the amount owed as arrears, with banks requested to suspend check processing transactions.

If payments are dishonored on several occasions with no reason given

- ✓ Banks can suspend the discounting of the bills, etc. and partially or fully suspend settlement operations

Incidentally, the electronic bills have been increasing in China since the launch of an electronic system for commercial bills of exchange in 2009. With this system, commercial bills of exchange can be managed online as electronically recorded monetary claims. As with the traditional paper-based

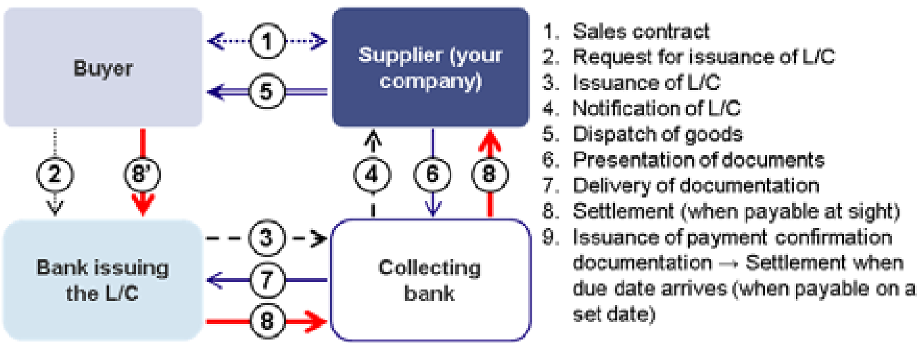
'Banker's acceptance bills' and 'Trade acceptance bills', these claims are divided into two types, namely 'Electronic banker's acceptance bills' and 'Electronic trade acceptance bills'.

In 2014, 18.421 million paper-based commercial bills were issued with a total value of RMB 19.3 trillion. In contrast, only 845,000 electronic commercial bills were issued with a total value or RMB 3.1 trillion[1.] This indicates an increasing use of electronic commercial bills especially for comparatively large settlements, given its low risk of forgery, theft or loss, less possibility of settlement delays or failure due to inadequate bills such as endorsements, and differences in maximum bill terms[2].

Finally, another settlement method is C, 'Domestic L/Cs'. Letter of credit, or L/C, usually refers to a payment promise issued by a bank for use in cross-border trade settlements. However, as the name suggests 'Domestic L/Cs' are letters of credit used only for settlement within China. Although this method merely accounts for a small proportion of total settlement payments in China, their use has been increasing in recent years.

'Domestic L/Cs' work much the same as L/Cs used in cross-border trade settlements. The transaction bank of the buyer issues an L/C at request, and promises to pay the supplier provided that documents fulfilling the L/C conditions are presented within the timeframe stipulated in the L/C (see Fig. 5). Also, as 'Domestic L/Cs' are only used for settlements within China, they are only denominated in RMB.

Fig. 5: Transaction flow of Domestic L/Cs



However, 'Domestic L/Cs' seems fraught with a number of risks compared to regular L/Cs.

Firstly, the governing rules are different. Regular L/Cs are governed by the Uniform Customs and Practice for Documentary Credit (UCP), a set of international rules established by the International Chamber of Commerce (ICC). The UCP has undergone a number of revisions since its establishment, and the latest version, UCP600, was revised in 2007. In

[1] Source: The PBOC's 'China Financial Stability Report'

[2] The longest usance period for traditional commercial bills was six months, while the longest usuance period for electronic commercial bills is twelve months.

contrast, 'Domestic L/Cs' are governed by the PBOC's "Measures on the Settlement of Domestic Letters of Credit", a set of rules that has not been revised at all since its introduction on August 1, 1997. In other words, the explanations and definitions in the Chinese rules still have plenty of room for further clarification and improvement compared to the latest international rules. Accordingly, discrepancies in interpretations of the criteria such as for assessing documentation may give rise to risks of non-payment.

Furthermore, regular L/Cs often include a Bill of Lading[3] in documents required. With these, the importer needs to settle the L/C (or promise to pay on the due date in the case of L/Cs with usance conditions attached) in order to receive the Bill of Lading needed to claim the cargo. In this sense, it avoids the risk of the importer absconding with the cargo. However, with domestic transactions, goods are usually transported overland, so in many cases no proof is required to collect the cargo. In other words, the buyer can claim the goods without paying (or promising to pay on the due date), meaning that the risk of non-payment cannot be completely ruled out even with domestic L/Cs[4].

Aside from the settlement risk, there is also an issue with convenience in this kind of settlement. To summarize, with settlements involving remittances or bills (especially 'Banker's acceptance bills'), there are a number of methods to obtain funds by collecting payments before the due date, and most banks (unlimited to Chinese banks) generally provide this kind of transaction. When it comes to 'Domestic L/Cs', such methods are extremely limited.

With regular L/Cs, companies can often obtain funds earlier by asking the counterparty banks to negotiate the L/Cs, yet this kind of transaction is seldom accepted with 'Domestic L/Cs'. In some rare cases, some Chinese banks will agree to negotiate only domestic L/Cs that they themselves or another branch of their own bank have issued. Consequently, mostly the only option open to the supplier is to request the counterparty bank to collect the funds on the due date, and even not every bank will handle this kind of collection process. As a result, this collection method seems quite inconvenient at this point in time, particularly with regard to bill settlements.

As outlined above, domestic L/Cs are still evolving as a means of settlement. In recent times though, buyers often ask about the possibility of switching settlement methods from traditional 'Banker's acceptance bills' to 'Domestic L/Cs'. At the moment, the companies requesting the issuance of 'Domestic L/Cs' and the banks issuing the 'Domestic L/Cs' are mainly Chinese. Then, what incentives are there for these companies and banks to switch to this settlement method? Though only on speculation, there are three possibilities. Firstly, unlike bills, domestic L/Cs are non-transferable[5], so it is easy to manage who the payee is, whereas with bills, the recipient can change through transfer by endorsement. Secondly, the deposit buyers need to pay

[3] This is a security that can be used as proof of ownership when claiming a shipment. It is also known as a B/L.

[4] However, this risk cannot entirely be ruled out with regular L/Cs either, with some B/Ls containing terms permitting direct courier of a Bill of Lading, for example.

[5] Regular L/Cs also include transferable L/Cs which, as the name suggests, can be transferred.

to get a bank to issue a domestic L/C is lower compared to banker's acceptance bills. Thirdly, some banks are prepared to negotiate domestic L/Cs, provided they themselves are the issuing bank. In this way, the banks can handle the entire settlement process themselves.

The next report, "Method of Settlements and Hedging Risks in China (Part 2)" will look at methods for hedging payment collection risk.