Potential Benefits from a Review of Settlement Currency Strategy

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Companies across East Asia are using an increasingly diverse range of currencies for the settlement of cross-border transactions, as a result of the expanded settlement currency options now available on the ongoing globalization of business operations, the prevailing market environment, and the relaxation of regulations in countries and regions across the globe. This article presents several cases to examine the potential benefits of settlement currency optimization based on a review of settlement currency strategy.

Diversification of Cross-Border Settlement Currencies

In East Asia, there can be seen increased trend of unconventional currency-denominated cross-border transactions, settled with currencies such as the Chinese Renminbi (RMB), in addition to the frequent-used the U.S. dollar (USD) and the Japanese yen (JPY). In 2014, 75 currencies were used in cross-border settlements in Hong Kong, 36 in China, 35 in Taiwan, and 44 in South Korea[1]. The rankings of cross-border settlement amount by currency of East Asian countries (Hong Kong, China, Taiwan, and South Korea) (Fig. 1) show that although USD continues to account for the largest percentage of total trade in all countries/regions, RMBhas come second in Taiwan, third in China and Hong Kong, and fourth in South Korea. Another feature is the use of local currencies other than the traditional international settlement currencies, with the New Taiwan dollar (TWD) ranking sixth in Taiwan and the South Korean won (KRW) ranking sixth in South Korea.

The reason behind this diversification lies evidently in its various merits. The following paragraphs present several cases of successful review of settlement strategy.

[1] This includes so-called “drawback remittances” that realizes a local currency denominated remittance through a combination of remittance and exchange.

Fig 1: Cross-border Settlement Amount by Currency in East Asia (2014)

	Hong Kong	China	Taiwan	South Korea
1	USD	USD	USD	USD
2	HKD	EUR	**RMB**	EUR
3	**RMB**	**RMB**	JPY	JPY
4	EUR	HKD	EUR	**RMB**
5	JPY	JPY	HKD	AUD
6	AUD	AUD	**TWD**	**KRW**
7	GBP	CAD	AUD	GBP
8	SGD	GBP	GBP	HKD
9	CAD	SGD	CAD	IDR
10	CHF	CHF	SGD	CAD

Source: Compiled by Mizuho bank, Ltd.

The benefits from a review of settlement currency strategy

[Case 1] Companies looking to cut the exchange costs of currency conversion

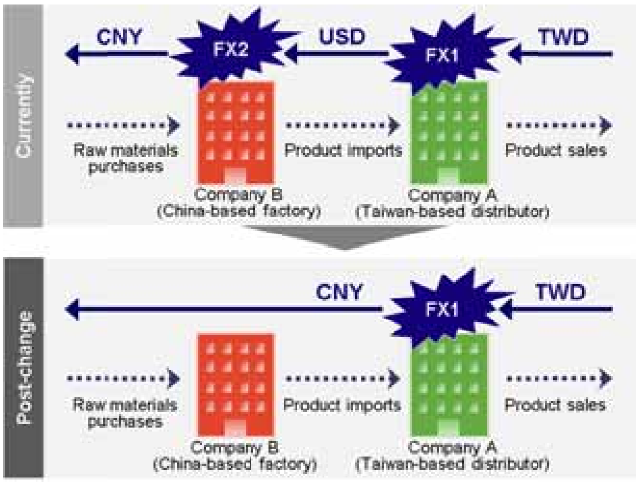
- Company A, a Taiwan-based sales subsidiary of a Japanese manufacturer, imports products from a group-owned factory in China (Company B) for sale in Taiwan.
- Company A uses TWD for sales in Taiwan, whereas the import/export contract between Company A and B is denominated in the U.S. dollar. Moreover, Company B uses the RMB to purchase raw materials in China.
- ・ It is likely that the currency conversions by Company A in Taiwan (TWD-USD) and Company B in China (USD-CNY) are generating unnecessary exchange costs.

Reduced exchange costs through introducing local currency (CNY) denominated settlements

Due to prior restrictions that RMB and TWD could only be used for payments within the respective territories, neither currency was available for cross-border settlements, therefore settlements had to be made using an intermediary currency, such as USD or JPY, as is this example. However, since China lifted the ban on the use of RMB in cross-border transactions in 2009 and authorized the use of RMB for transactions with Taiwanese residents in February 2013, RMB has become available for use in the settlement of bilateral trade between China and Taiwan.

In this case, the introduction of RMB as a settlement currency would allow Company A to convert TWD directly into RMB in Taiwan for remittance to Company B and make these RMB funds available to Company B for payments in China without recourse to further currency conversion. This would halve the number of currency conversions (from two to one), thereby reducing the exchange costs involved in the bilateral trade (Fig. 2). According to estimates by the Financial Supervisory Commission of Taiwan when the ban on RMB transactions with Taiwanese residents was lifted, such exchange cost reduction could reduce corporate settlement costs by approx. TWD 50 billion per annum (approx. JPY 190 billion).

Fig 2: An illustrative example of a reduced number of currency conversions



Source: Compiled by the Asia Transaction Banking Division, Mizuho Bank, Ltd.

This effect is not limited to RMB. As seen in this example, using the local currency of either the remitter or the recipient in cross-border remmittance could reduce the number of currency conversions (thus reducing the exchange costs).

[Case 2] Companies looking to cut the financing costs in China

- Company C is a China-based manufacturing subsidiary of a Japanese manufacturer.
- Company C is considering new financing for purchasing equipment necessary to expand its production line, but is concerned that its position as a newly established enterprise will prevent it from obtaining a loan directly from a Chinese bank, and has heard that loan interests in China are high.
- Meanwhile, Company D, a Hong Kong-based group company, and Company E, a Taiwan-based group company, are cash-rich and are looking for ways to utilize their surplus funds.

<u>Reduced financing costs through offshore loans</u>

To date, financing in China has mainly been realized through local bank loans. However, with the ease of various regulations and a growing need for more efficient fund management across the group, multinationals are increasingly making use of inter-group financing among onshore group companies (within mainland China) and offshore group companies (outside mainland China) to finance their operations.

In this case, the inter-group loan provided by the cash-rich group companies in Hong Kong or Taiwan to Company C would enable the company to secure stable funding at a comparatively low cost without having to borrow from a Chinese bank. At the same time, it would enable Companies D and E to obtain a higher yield from fund management and avoid an expanded (consolidated) balance sheet of the group as a whole.

Meanwhile, due caution is needed for similar cases with external debt for Chinese companies, with respect to the limit on loan amount that are calculated on the basis of the so-called “foreign debt borrowing gap” (the difference between a company’s total investment amount and its registered capital), restrictions on the use of borrowed funds, and the withholding tax imposed on the interest payable on external debt.

Such merits apply not only to China. Especially in emerging markets of Asia, inter-group loans offer a way to reduce financing costs in cases where newly-established local subsidiaries experience poor credit worthiness or in countries where financial regulations make for a restricted financing condition and high interest rates.

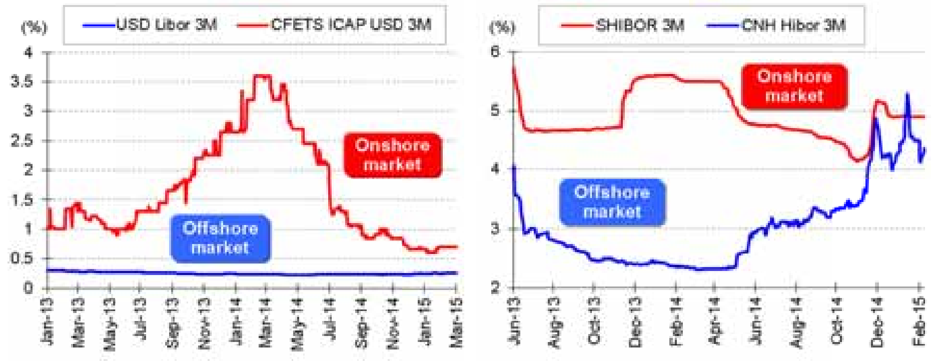
[Onshore and offshore financing conditions (in China)]

A comparison of onshore and offshore financing conditions in China generally finds a more restrictive environment for onshore financing, whether in a foreign currency or in RMB. This is mainly due to the the tight control by the Chinese authorities, using the so-called “principle of real demand” to control onshore/offshore free capital movements, and the strict management of the use of onshore funds to prevent speculative transactions.

A comparison of the China-related USD interbank interest rates (3-month rates) points to a narrowing spread, with the latest onshore rate at around 0.75% and the offshore rate at around 0.25%. However, in March 2014, the spread was more than tenfold, with onshore rate at around 3.5% and the offshore rate at around 0.25% (Fig. 3).

Likewise, although RMB interbank rates (3-month rates) also point to a convergence of onshore and offshore funding costs in recent quarters, in principle, offshore rates remain lower (Fig. 3).

Fig 3: A comparison of USD interest rates (left) and RMB interest rates



Source: Bloomberg, Reuters

[Case 3] Companies looking for centralized foreign exchange risk management by regional headquarters to enjoy other new financial benefits

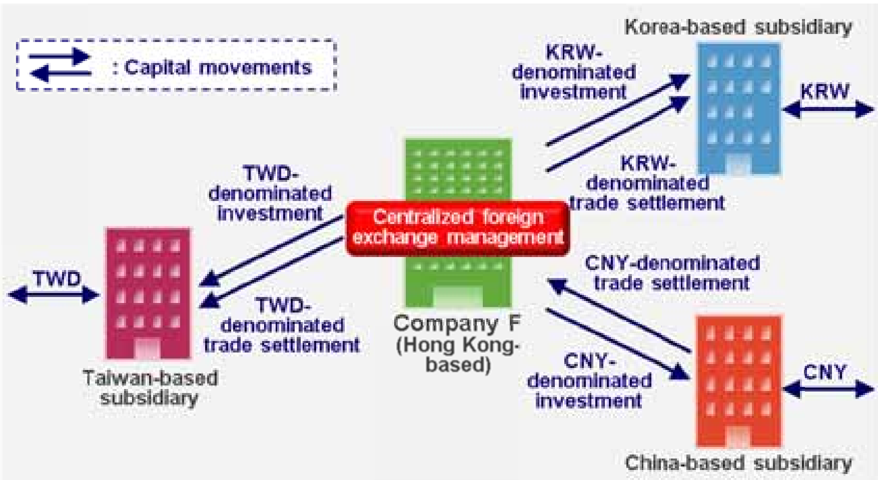
- Company F is the Hong Kong-based regional headquarters of a Japanese manufacturer. It oversees all subsidiaries in the East Asia and, in principle, mediates all inter-group trades across the region.
- Previously, each group company undertook the exchange risk associated with their own transactions. However, the regional headquarters has started to seek for a centralized exchange risk management in response to the Japanese head office's request to tighten internal controls.
- ・ Moreover, Company F hopes to actively enjoy the new financial benefits to be derived from this solution.

Local currency denominated settlement would pave the way for centralized foreign exchange management

Traditionally, USD is most used for the settlement of numerous transactions among the group's Hong Kong-based regional headquarters and other group companies, with these latter being required to bear the foreign exchange risk associated with converting USD into the local currencies (RMB, TWD, or KRW, etc.). However, a request from the Japanese head office to tighten internal controls has made centralized foreign exchange risk management by the regional headquarters a more pressing demand.

In this case, shifting the currencies in which contracts among Company F and its group companies are denominated and/or the settlement currencies to the local currency in each country/region where its group subsidiary is located would allow the Hong Kong-based regional headquarter to realize a centralized foreign exchange risk management (Fig. 4).

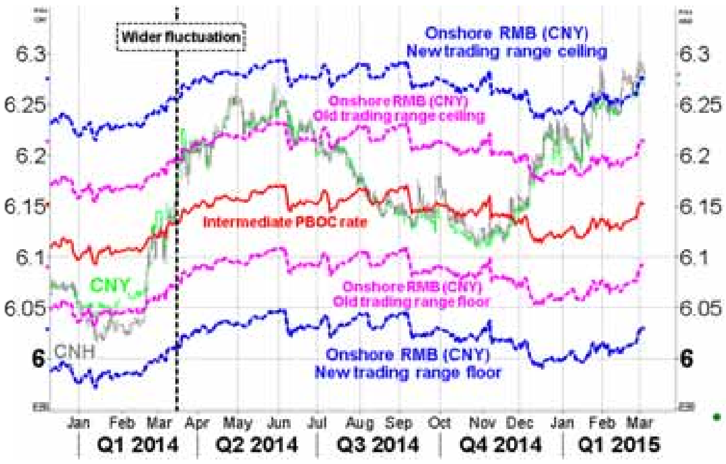
Fig 4: A Schematic Overview of the Centralized Management of Foreign Exchange Risk by a Regional Headquarters



Source: Compiled by the Asia Transaction Banking Division, Mizuho Bank, Ltd.

Also, were it to introduce RMB for trade settlement with group companies in China, it would reap new financial benefit from the gap between onshore RMB (CNY) and offshore RMB (CNH) market rates[2] (Fig. 5 and 6).

Fig 5: Trends in Onshore RMB (CNY) and Offshore RMB (CNH) Market Rates



Source: Compiled by the Asia Transaction Banking Division, Mizuho Bank, Ltd.

Fig 6: Availability of RMB (CNY/CNH) to offshore companies (outside mainland China)

Currency type/purpose		Availability	
		CNY	CNH*
Current account settlements	(1) Payment for imports/exports of goods	Yes**	Yes
	(2) Payments for trade in services and other transactions, including: – Royalty – Dividend – Commission – Service fees	No	Yes
Capital account settlements	(3) Shareholder (inter-group) loan	No	Yes
	(4) Equity capital (for establishment of a company or capital increases)	No	Yes
	(5) Mergers, acquisitions and equity transfers	No	Yes

* Where CNY deposits are to be used to make settlement, they are handled as CNH transactions

** The use of the CNY for RMB-denominated settlements between two offshore companies with no concern with mainland China is prohibited.

Source: People's Bank of China, Hong Kong Monetary Authority, etc.

Source: Compiled by Mizuho Bank, Ltd.

Conclusion

In convention, currencies such as USD, EUR, JPY would generally spring to mind in any discussion of cross-border settlement, but as this article has demonstrated, companies in East Asia has already begun to enjoy multiple benefits through settling with dozens of variegated national currencies.

Meanwhile, for Japanese companies, whilst commercial distribution and capital flows between Japan and overseas regions have predominated to

[2] In principle, onshore exchange of the Chinese currency is denominated in CNY whereas offshore exchange in CNH. However, if the offshore exchange is related to a trade settlement with mainland China, the offshore company (in this case, Company F) can exchange at whichever rate that is more advantageous (USD/CNY or USD/CNH).

date, there is an increasing volume of cross-border trade flow and capital flow among foreign nations and regions (including Asia) triggered by ongoing globalization.

Moreover, ease of foreign exchange restrictions in various countries and regions offers increased cross-border settlement options open to companies. It can be predicted that more and more moves to review "settlement currency strategy" in pursuit of new benefits shall be taken in the years to come.

[Remarks] This report is a translation of the original report in Japanese published on April 2, 2015. In the event of any discrepancy, the original report in Japanese shall prevail.