

# The Asia Era Redefined – New Products, Markets and Institutions

Peter Wong, Founding Chairman and President of the International Association of CFOs and Corporate Treasurers (China) and Convenor of the Hong Kong Association of Corporate Treasurers

- The credit crisis has highlighted the importance of liquidity risk management for corporates and a renewed assessment of bank relationships.
- Now more than ever, corporate treasurers must follow best practices in treasury management as global de-leveraging will lead to a shortage in the supply of credit and a much higher cost of borrowing.
- With the future of Asia tied to that of China, the Mainland government has recognised the need to strengthen the financial institutional infrastructure.
- In Asia Pacific as a whole, while the region enjoys a good economic growth momentum, much needs to be done if its treasury and capital markets are to reach the next level of sophistication.

As the turmoil in the financial markets unfolded in 2008, the financial landscape has changed almost completely. The impact of the credit crisis has reverberated globally. The banking system is under stress on a scale it has never faced since the Great Depression in the 1930s. The financial system today is more integrated and global but is also more complex and harder to regulate. Against this backdrop of global de-leveraging, Asia is facing the prospect of reduced demand of its exports and diminishing inflow of foreign direct investment (FDI). The aim of this article is to discuss how treasurers in Asia can respond to these challenges and what further developments in products, markets and institutional infrastructure are required to take cash and treasury management standards in Asia to the next level.

## Cash is King

The severe global credit contraction highlights the importance of liquidity risk management and a renewed assessment of bank relationships by organisations. First and foremost, corporate treasurers require immediate visibility of their company's global or regional cash position, and for the Asian corporate treasurer, who needs to mobilise cash within the Asian time zone, this means that the regional treasury centre must be equipped with the capability to settle US dollar (USD) payments without the need to wait to settle overnight. This also avoids the gridlock if

banks refuse to offer a daylight overdraft facility. The Regional CHATS (Clearing House Automated Transfer System) developed recently by the Hong Kong Monetary Authority (HKMA) and fully supported by the Treasury Markets Association<sup>1</sup> is a timely solution to achieve this goal. Launched in July 2007, the Regional CHATS aims to attract regional cross-border payments in Hong Kong dollars (HKD), USD and euros (EUR) to be made through Hong Kong by pooling together the existing correspondent banking network built by individual banks. It facilitates payments to be effected within the Asian time zone, thereby enhancing both the settlement efficiency and liquidity of a bank. Regional CHATS has been well received by the market and, as of July 2008, 34 banks in Hong Kong had registered as service providers for cross-border payment services, covering more than 2,000 payment beneficiary points in around 50 economies.<sup>2</sup>

1. See [www.tma.org.hk](http://www.tma.org.hk) – of which the author is an Executive Board member.

2. Statistics provided by the Hong Kong Monetary Authority.

While keeping all the company's cash with one bank offers maximum flexibility in terms of movement of liquidity, the concentration of risk is also a concern. Having the infrastructure available to invest short-term cash with sovereign treasuries becomes necessary. If a company's cash position has to be spread over multiple banks, the use of SWIFT<sup>3</sup> technology to monitor and move cash between banks offers treasurers the flexibility and preservation of proprietary information as to how the company's cash is being deployed. But when a bank's balance sheet is at risk, treasurers face uncertainty in getting the bank's continuous support in rollovers and drawdowns. The company's deposit with the bank may be frozen to offset loan outstanding. Therefore, monitoring the financial health of banks through a robust credit risk management process has become important.

On the operations side, a back-up arrangement is needed to ensure the gridlock is removed when one bank becomes reluctant to offer "business as usual" arrangements, from requiring pre-funded settlement of foreign exchange to suspension of a daylight overdraft facility. Treasurers need to understand and push for the use of Continuous Linked Settlement (CLS)<sup>4</sup>, which allows payment-versus-payment (PVP) settlement of foreign exchange trade, and Asian financial regulators should work towards having more Asian currencies included in the CLS scheme beyond the Australian dollar, HKD, New Zealand dollar, Singapore dollar, won and yen. An alternative to using the CLS is to make use of the inter-linkage of the EUR, HKD and USD clearing systems in Hong Kong to settle USD/HKD, EUR/USD and EUR/HKD foreign exchange transactions on a PVP basis. To promote liquidity and mitigate settlement risk, settlement of corporate bond trades should adopt a delivery-versus-payment (DVP) solution.

## Raising the Bar

Global de-leveraging will lead to a shortage in the supply of credit and a much higher cost of borrowing. As a result, capital management will need to be more rigorous. Project rationing will become more demanding and business units will be under closer scrutiny to track the return on risk-adjusted cost of capital as one of their key performance scorecard measures. Treasurers need to explore various new frontiers of corporate finance and risk-transfer solutions. On the other hand, there are opportunities for well-capitalised companies to expand through mergers and acquisitions.

In today's complex financial market, no company is immune to the chain reaction generated by a confidence crisis. The speed of a downturn precludes a response short of crisis management. The mandate is paramount on treasurers to ensure the survival of a corporation by ensuring available liquidity at all times. Shareholders and regulators will in time place liquidity and enterprise risk management as a much higher corporate governance priority and as a sustainability objective that is as essential as the need for an audit committee to ensure adequate control and integrity of financial disclosure.

The following are some treasury management best practices that can help treasurers weather the storm of a liquidity crunch:

- ▶ **Do not be penny wise but pound stupid:** Pay a fee to maintain committed facilities with a panel of banks that is diversified by geography (e.g. Chinese, Asian, European and US banks) and the banks' funding source (e.g. interbank, retail deposit base, etc.) to reduce concentration risk.
- ▶ **Back to basics:** Match the company's debt repayment schedule with its operating cash flow and committed facilities. Focus on internal and supply chain processes to improve efficiency.
- ▶ **Control asset/liability mismatch risk:** Tap the bond market to extend the company's debt maturity profile to avoid funding long-term assets with short-term debts or a working capital loan. There is a strong case for developing the domestic corporate bond market in many Asian countries, particularly in China and India.

3. *SWIFT (Society for Worldwide Interbank Financial Telecommunication) is the cooperative organisation created to facilitate the transfer of information and payment/advice instructions between member banks, securities organisations and corporate customers. See [www.swift.com](http://www.swift.com).*

4. *Continuous Linked Settlement is the world's largest multi-currency cash settlement system, eliminating settlement risk for over half the world's foreign exchange payment instructions. It is operated by CLS Bank, see [www.cls-group.com](http://www.cls-group.com).*

- ▶ **Be liquid and safe:** Stringent investment criteria have to be in place to ensure assets will not suffer a heavy haircut when converted to cash. A deep and liquid secondary market for domestic bonds is therefore important to reduce the “liquidity premium” demanded by investors.
- ▶ **Strike a balance:** Look at the interaction between business risk and financial risk and determine the right level of risk tolerance for the company.

## China and Asia

The future of Asia is tied to the future economic reforms of China. This year (2008) marks the 30th anniversary of China’s initial reforms to transform itself from a centrally planned to a state-controlled market economy.<sup>5</sup> With China’s economic growth path firmly established, the emphasis is moving away from quantity to *quality* of growth, and with this, there is a recognition by the Mainland government for the need to strengthen the country’s institutional infrastructure.

China has the world’s largest foreign exchange reserves of more than USD1.8tr (July 2008) compared with less than USD200m when it became a member of World Trade Organization in 2001.<sup>6</sup> Therefore, China should be less dependent upon its trade surplus and FDI inflow to finance its growth. Its challenges today lie in the deepening of its reforms, stimulating domestic demand and the sustainability of economic growth.

China’s successful export performance has spurred growth of the value of intra-Asian trade, which has now surpassed European-Asian as well as transpacific trade, as economic integration between China and other Asian countries increases. While China has a trade surplus with the US and Europe, it has a deficit with other Asian countries. Economic relations between China and the rest of Asia are expected to deepen. By 2010, the 10 countries of the Association of Southeast Asian Nations (ASEAN) will commence a new free trade area relation with China.<sup>7</sup> Supply chain management and customised treasury (e.g. electronic banking) solutions for small and medium-sized enterprises will be future growth areas for cash management product development.

As part of its regulatory and economic reforms, the Chinese government is relaxing currency control regulations. Under new State Administration of Foreign Exchange (SAFE) rules, effective in August 2008, Chinese enterprises are no longer required to remit back their hard currency to the Mainland (Clause 1.9), and Chinese banks are allowed to provide foreign currency overseas loans (Clause 3.20).<sup>8</sup> Multinational corporations that had cash “trapped” in China under the previous regulatory regime can now apply to SAFE to lend its foreign currency to their underfunded overseas subsidiaries.

## The Next Level of Sophistication

Asia is the next growth market for global cash management banks. For treasurers in the region, there is scope for improving liquidity and cash management. While cross-border pooling is currently restricted by cross-border withholding tax issues and the absence of a pan-Asian currency, liquidity management products (e.g. regional interest optimisation or cash balance aggregation) offer treasurers opportunities to improve yield on a regional basis. For cash management, the use of electronic collection channels via the Internet, mobile banking and automated teller machines (ATMs) as well as retail points of sale (e.g. the post office and convenience stores) will in time surpass paper instruments (i.e. cheques and bank drafts) as the preferred payment mode. The use of payment factories (either centralised in a national treasury centre such as Shanghai for China, or offshoring to locations such as the Philippines, Malaysia and India) in the form of

5. To mark this milestone, a treasury management conference organised by the China Association of CFOs and the International Association of CFOs and Corporate Treasurers (China), in collaboration with the Ministry of Finance, is scheduled to take place in Beijing in December 2008.

6. Data posted on the People’s Bank of China web site, [www.pbc.gov.cn](http://www.pbc.gov.cn).

7. For an overview of ASEAN and China relations, see [www.aseansec.org/4979.htm](http://www.aseansec.org/4979.htm).

8. For SAFE rules and regulations, see [www.safe.gov.cn](http://www.safe.gov.cn).

a shared service centre is becoming more commercially viable as the electronic exchange of payment files between corporates and banks in a straight-through processing manner becomes popular.

The recent sub-prime-related financial turmoil has highlighted the need to diversify bank relationships to include both international and local banks for both funding and transaction needs. SWIFTNet technology offers engines to capture multi-bank cash balances via MT940 and cash concentration via MT101 messages.<sup>9</sup>

In order to promote the interoperability between the real-time gross settlement (RTGS) systems in Hong Kong and SWIFT, the HKMA has kickstarted a project to migrate its various RTGS systems, which currently operate on a closed and proprietary platform, to SWIFTNet. One of the major benefits brought by the migration is to facilitate straight-through processing of banks' overseas payments, thereby enhancing Hong Kong's status as the payment and settlement hub in the Asia-Pacific region. The project is planned to be launched in two phases: the first phase will be delivered in May 2009 and the second phase in 2010.<sup>10</sup>

As banks are now more credit-risk adverse and stricter in the deployment of capital, corporate treasurers should explore asset-based lending (e.g. covered bonds, receivable securitisation) when conventional cash flow lending requires a steep premium. There are also opportunities related to the emergence of Islamic financing as an alternative source of funding. The Hong Kong government is focusing on this as a priority. In order to develop Hong Kong into a centre for Islamic finance, the HKMA has been enhancing the readiness of its financial infrastructure platform to facilitate Islamic-related payments to be settled in Hong Kong. This includes the introduction of a new payment code to the RTGS systems for the identification of Islamic-related payments and providing financial institutions with the flexibility of setting up an additional settlement account in the USD and EUR RTGS systems for the segregation of funds. The former has been in effect since 16 September 2008, while the latter will be in place from 17 November 2008.

## The Role of Pan-Asian Cooperation

As mentioned, governments and regulators have a crucial role in easing gridlocks in the financial markets. In addition, corporate treasury as a professional group has a major role by promoting best practices and responding proactively to policy reforms to ensure the principles of market efficiency and stability are upheld.

The International Association of CFOs and Corporate Treasurers (China) [IACCT (China)], the Hong Kong Association of Corporate Treasurers, the Association of Corporate Treasurers (Singapore) and the Finance and Treasury Association of Australia have initiated the Asia-Pacific Treasury Forum (APTforum) to promote pan-Asia-Pacific dialogue among corporate treasurers based in the region. EuroFinance, part of The Economist Group, is an active promoter of this initiative and hosts APTforum discussions at its flagship conferences in Singapore and Shanghai. Since the APTforum's inception in May 2006, more than 200 treasurers have participated in these knowledge leadership discussions.<sup>11</sup>

The APTforum plans to create a network of Global Asia 100 and Global China 100 treasurers to further strengthen a core group of treasurers for networking and sharing views on market developments in Asia and China. Through the author's advisory role with SAFE, and briefing sessions in Beijing, IACCT (China) members may consult with Chinese regulators and share their views on China's financial reform.

## The Role of Regulators in Institutional Infrastructure

In a statement on 19 September 2008, the US Treasury Secretary, Henry M. Paulson, Jr, said: "... this [credit] crisis demonstrates in vivid terms that our financial regulatory structure is sub-optimal, duplicative and outdated," and that he is searching for a "modernised financial oversight structure".<sup>12</sup> His speech should be a

9. SWIFTNet is SWIFT's advanced Internet protocol-based messaging solution, which uses standard message types (MT) including MT940 for a customer statement message and MT101 for a request for transfer.

10. See HKMA's 2007 Annual Report, [www.info.gov.hk/hkma/eng/public/ar07/pdf/15\\_market.pdf](http://www.info.gov.hk/hkma/eng/public/ar07/pdf/15_market.pdf).

11. For more information about the APTforum, see the IACCT (China) web site, [www.iacctchina.com](http://www.iacctchina.com).

12. See US Department of the Treasury statement dated 19 September 2008, [www.ustreas.gov/press/releases/hp1149.htm](http://www.ustreas.gov/press/releases/hp1149.htm).

wake-up call to Asian financial regulators. The role of regulators is being challenged by the trend of financial convergence. An integrated approach is needed to understand the systemic risk embedded within all kinds of financial institutions and their correlative risk. There is a fine line between prudent risk management and bureaucratic rule-based control. The focus should be on early-warning monitoring and improved transparency rather than micro-management. The reality is that market change is complex and the financial markets are a moving target. Regulators need to be fully aware of changes and be able to come up with effective policies and timely responses that can remove any gridlocks in the markets. For the development of a capital market at retail level, regulators need to provide more investor education on risk tolerance and the behaviour of investment products in different market conditions. In addition to transparency of rules, maintaining a close dialogue with market participants is becoming more important. The economic cost of a dysfunctional financial value chain has far-reaching consequences for the whole of society.

## In China

The Chinese government is keen to encourage Chinese enterprises to tap into the bond market. IACCT (China) actively supported this initiative by organising a visit by an international delegation of representatives from the International Group of Treasury Associations to the China Securities Regulatory Commission. It also organised a conference covering renminbi (RMB) corporate bond market development and treasury risk management for Chinese enterprises that are members of the Association of the Shanghai Board of Secretaries and the Shanghai Accounting Society.

For Chinese enterprises expanding offshore, SAFE has promulgated policies to encourage Chinese enterprises to issue foreign currency bonds to avoid currency mismatch when, for example, investing in USD assets but financing in RMB. This was a theme discussed at the annual SAFE Advisory Forum held in Tianjin in June 2008.

Rating agencies have an important role in the development of China's capital market as they act as catalysts to enhance transparency and raise awareness on risk management. Regulations need to be carefully enacted to discourage "rating shopping"<sup>13</sup>. Rating agencies, particularly international entities such as Fitch, Moody's and Standard & Poors<sup>14</sup>, can add significant value in raising the risk assessment standard of the domestic bond market. By allowing international rating agencies to rate RMB bonds and the global bonds of Chinese enterprises, both issuers and investors can benefit from consistency in rating methodology in both domestic and global capital markets, which can help to reduce overall funding costs and broaden the investor base. Given the size of the Chinese economy and diversity of its industries, the Chinese corporate bond market has ample room to grow.

In 2008, Chinese enterprises started to report their financial results in accordance with the new Chinese Accounting Standards (promulgated by the Ministry of Finance), which is largely in convergence with international standards. This is an illustration of how Chinese regulators are helping to raise standards in the Mainland capital market.

## In Asia

Given the USD4tr<sup>15</sup> of foreign exchange reserves in Asia alone, it is natural for part of this sum to be reinvested in the region. In Asia, corporate bonds are an asset class that needs to be developed relatively quickly to mobilise long-term savings into productive investment.

Asia should also reassess the virtue of having an Asia-focused capital market developing body or rating agency to help establish a sound credit culture among financial institutions and investors in the region. This

13. "Rating shopping" is when an issuer of securities chooses a rating agency that will assign the highest rating or that has the least stringent criteria for achieving a higher rating.

14. See [www.fitchratings.com](http://www.fitchratings.com), [www.moody.com](http://www.moody.com) and [www.standardandpoors.com](http://www.standardandpoors.com) for more information about these rating agencies.

15. See the International Monetary Fund's web site for a list of countries' monthly international reserves and foreign currency liquidity, [www.imf.org/external/np/sta/ir/8802.pdf](http://www.imf.org/external/np/sta/ir/8802.pdf).

can be achieved through active training of banks and investors as well as a more sophisticated credit and risk monitoring system for domestic financial institutions and investors. This Asia-based agency can focus on the corporate bond market, particularly through working with each Asian jurisdiction in areas such as investor education, and removing roadblocks in creating an efficient and liquid secondary trading infrastructure. Issues to consider include:

- ▶ Harmonising interest withholding tax so that corporate bonds are tax-neutral in relation to traditional bank financing;
- ▶ Allowing certain high-grade corporate bonds to be accepted as bank reserve assets;
- ▶ Measures that encourage cross-border investment in corporate bonds to facilitate recycling of savings from one Asian jurisdiction to another;
- ▶ Alignment of regulatory restrictions (e.g. corporate bond as a percentage of assets) for investment exposure limits for pension funds and insurance companies for this asset class;
- ▶ Removal of roadblocks (e.g. withholding tax) to promote the development of repurchase agreements for corporate bond to improve market liquidity; and
- ▶ Determining the feasibility of establishing a Euroclear<sup>16</sup>-type institution in Asia, similar to the Central Moneymarkets Unit<sup>17</sup>, to reduce settlement risk and promote the use of Asian corporate bonds in collateral management.

## Conclusion

Corporate treasurers play a critical role in managing liquidity risk and bank relationships during a financial crisis. Not only is having a contingency plan to ensure liquidity essential, treasurers need to make sure it can be executed effectively, particularly during extreme risk events. Centralised treasury information, good treasury management systems, smooth treasury operational procedures and arrangements with banks are essential to ensure liquidity flow and uninterrupted trade settlement at all times.

Asia Pacific has a good economic growth momentum but there is much to be done if the region's treasury and capital markets are to reach the next level of sophistication. The Governor of the People's Bank of China, Zhou Xiaochuan, has urged for more cooperation among Asian central banks in determining the policy response on factors that impact the financial development and stability in the region.<sup>18</sup> By the same token, the treasury profession should liaise with the banks, regulators and market participants to ensure changes in products, markets and institutional infrastructure meet the changing needs of the industry.

16. Euroclear is a user-owned financial services company based in Brussels, Belgium, that operates the world's largest settlement system for securities transactions. See [www.euroclear.com](http://www.euroclear.com).

17. The Central Moneymarkets Unit is a clearing system operated by the HKMA for the clearing, settlement and custodian facilities for Exchange Fund Bills and Notes, bonds issued by the Hong Kong Government, and debt securities.

18. See *China Daily* article, dated 29 July 2008, [www.chinadaily.com.cn/bizchina/2008-07/29/content\\_6885825.htm](http://www.chinadaily.com.cn/bizchina/2008-07/29/content_6885825.htm).