MARKET INFRASTRUCTURE

The Redback comes of age:

managing risks and harnessing opportunities in offshore renminbi

The internationalisation of the Chinese renminbi has picked up pace this year, with a growing volume traded in the offshore currency. But its path to becoming a major international currency in its own right still has some way to run, writes Joel Clark

It is now the world's second largest economy after the US, and its annual GDP growth rate has averaged nearly 9% over the past five years. By any yardstick, the growth of China's global influence has been staggering, but up until fairly recently, its currency was still tightly restricted and virtually inaccessible to international investors.

That has now begun to change, and a process of liberalisation that began in 2010 has been gathering pace, to the extent that there is barely a bank or trading platform in the FX market that has not put a major focus on offshore renminbi (RMB), known in the industry as CNH. And while Hong Kong may have been instrumental in driving the process, other Asian and European financial centres are vying to attract RMB business as the excitement about the currency continues to spread.

"For China to have a freely tradeable currency proxy is truly revolutionary, especially after decades of restrictions which ensured the currency was all but off-limits to international investors. The creation of the CNH market was initially aimed at supporting Chinese firms involved in global cross-border trade settlement, but in turn it has also created opportunities for international investors," says Gary Lin, head of foreign exchange Hong Kong at Brown Brothers Harriman (BBH).

In an industry that has been beset this year by structural and macroeconomic challenges that have made it harder than ever to make money out of currencies, RMB is one of the few bright spots on the horizon, and certainly the largest. But liberalising a currency is a complex and technical process, and while there are clearly very legitimate opportunities associated with RMB, there are also risks that must be carefully managed.

Investors seeking access to China's currency historically had two options: the onshore deliverable market, which was tightly restricted by the Chinese government and very difficult to access from outside China, or the offshore non-deliverable market. The offshore market, traded through non-deliverable forwards (NDFs), allowed transactions to be settled in US dollars but was not an ideal solution for many investors, due to pricing concerns.

The development of offshore trading of RMB means that market participants can now use the currency from outside China in a deliverable format as they would any other major currency, without being restricted to using only NDFs. Since the process of internationalisation began, use of NDFs appears to have declined – the London share of NDFs in all renminbi forwards dropped by 25% between 2010 and late 2013, according to data collected by the London Foreign Exchange Joint Standing Committee.

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Gary Lin

"Investors have grown comfortable with the lack of trading restrictions, the increased stability of the currency through greater liquidity, the reduced operational hurdles and the increased correlation to the onshore currency, all of which are generating investor confidence and further demand. The result of this propeller effect has been a drastic increase in CNH market trading volumes, pushing it clearly ahead of CNY NDFs as the most favoured route to RMB exposure for offshore investors," says Lin.

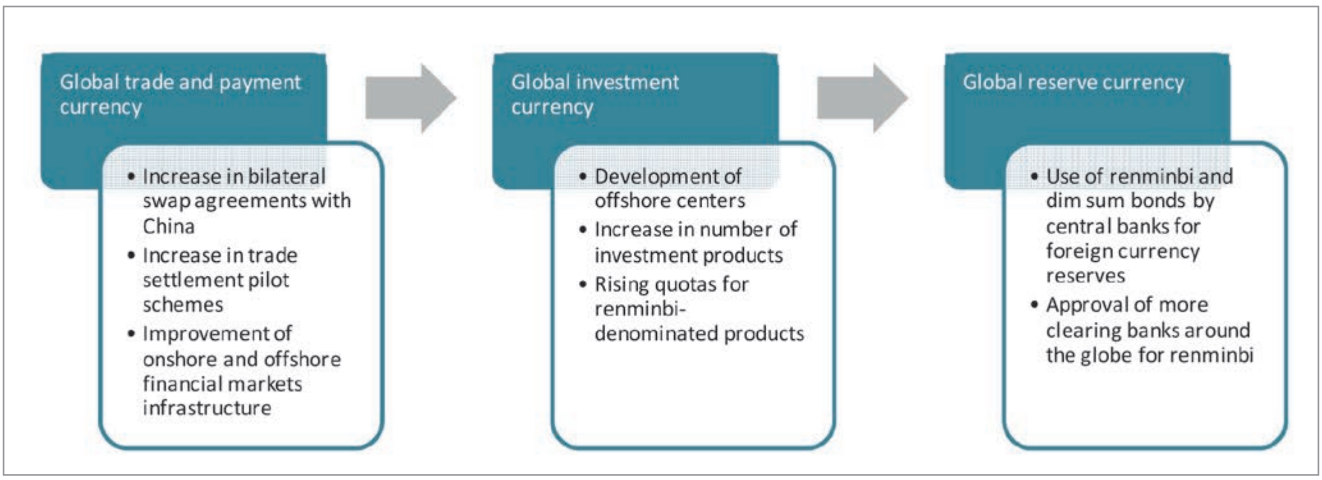
VOLUME GROWTH

The liberalisation of renminbi has been progressed through a series of individual measures over the past five years, ranging from the initial introduction of a cross-border trade settlement pilot scheme to the creation of swap lines with numerous central banks around the world, the launch of direct trading with other major currencies and the appointment of RMB clearing banks in several offshore centres.

The path to full convertibility of the currency is by no means complete, but the measures taken so far have clearly had a positive impact in opening up renminbi to international participation. The currency is now the ninth most traded global currency, with a 1.1% share of daily trading flow, according to the 2013 triennial survey of FX market turnover by the Bank for International Settlements. Renminbi had risen from 17th position in the 2010 survey, with just 0.45% of daily flow at that time.

Electronic platforms are also reporting exceptional growth in renminbi trading. CNH is typically among the top four traded pairs by volume on Thomson Reuters Matching, which facilitates interbank trading for over 200 institutions, and in March the currency entered the top 10 traded pairs on Fxall, one of the leading and continually growing multi-dealer-to-client platforms in the market also owned by Thomson Reuters.

"Thomson Reuters has been integral in bringing renminbi to the heart of the global currency system and is helping to facilitate its growing internationalization. We have been facilitating RMB foreign exchange and fixed income trading for a number of years now, notably in offering offshore renminbi reference rates to foreign exchange and money markets. In fact, we are also a primary electronic market for



Source: Aite Group

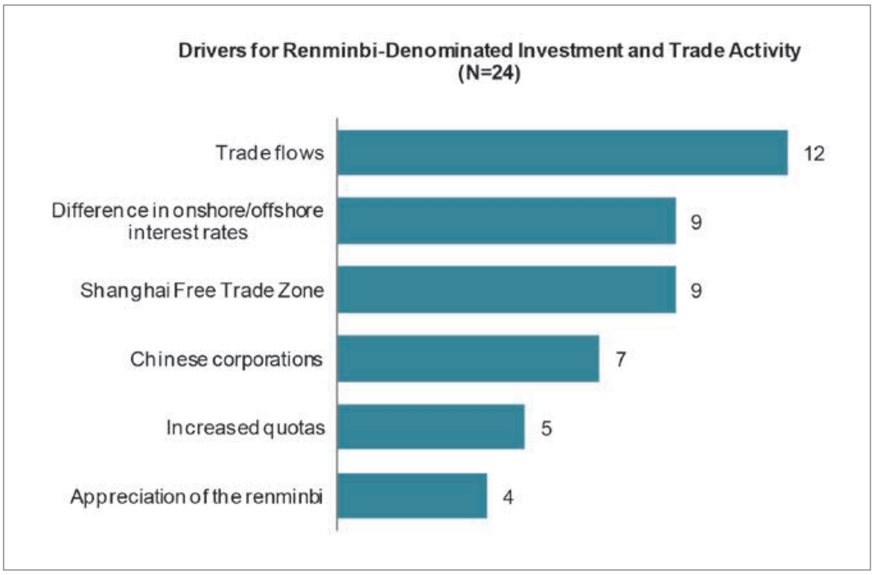
Progress Toward Internationalization of the Renminbi interbank spot RMB – our volumes are up over 400% since Q1 – and we have been facilitating RMB bond trades, particularly in Europe," says Jim Kwiatkowski, global head of sales at Thomson Reuters.

Thomson Reuters has compiled and published Hong Kong's first offshore RMB spot fixing rate since 2011, and last year it started calculating and publishing the offshore renminbi Hong Kong Interbank Offered Rate (CNH HIBOR) benchmark.

"The CNH HIBOR fixing, covering tenors from overnight to 12 months, acts as an important piece of information infrastructure for the market. Not only does it provide a benchmark for the pricing of loans but it also facilitates the development of a variety of interest rate products, helping institutions manage their RMB interest rate risks," says Adrian Gostick, managing director for Global Growth and Operations China at Thomson Reuters.

Meanwhile ICAP's EBS currencies trading business, which has seen

Adrian Gostick



Source: Aite Group survey of 24 firms active in the Chinese market, Q1 and Q2 2014

Respondent Views on Drivers for International Use of the Renminbi

a fall in volume in some of its core pairs as a result of low volatility, has put a major strategic focus on CNH as it transacts ever greater volume in the currency. Neither Thomson Reuters nor EBS are yet in a position to reveal actual volume figures, but CNH is typically within the top 8 traded pairs on EBS and often in the top five, says Darryl Hooker, head of EBS Market, the flagship anonymous trading platform. Up to 20% of CNH volume on EBS is now transacted through EBS Direct, the newer relationship-based disclosed platform that launched last year.

"We have had RMB available on EBS Market since 2010 and we've seen very significant growth over the past year. We spent three months in Hong Kong earlier this year with the aim of building our franchise in the currency, and during that time we increased our business 10-fold. We now have more than 120 institutions trading CNH on a daily basis and a team of five people globally focused on the currency," says Hooker.

"The CNH HIBOR fixing, covering tenors from overnight to 12 months, acts as an important piece of information infrastructure for the market."

The growth in CNH volume is driven by the need of an increasing number of institutions, including traditional asset managers, hedge funds, insurance companies, corporations and central banks, to access renminbi. As their confidence in using the currency offshore increases, so too does liquidity.

"As the offshore CNH market matures, it will continue to be a more common and comfortable currency to trade. Investors are overcoming initial operational struggles. Correlation with the onshore CNY market has continued to increase and volatility has decreased, all driving greater liquidity and stability in this new market. Positive sentiment is apparent as global investors are introducing more creative offshore RMB investment vehicles such as CNH overlay strategies, expanding available channels to access exposure to China," says Lin of BBH.

BENEFITS FOR CORPORATES

For international corporations that deal with China, being able to access the renminbi market also offers a number of benefits, including the reduction of currency exposure and transaction costs. Corporates can now pay and receive in RMB rather

Most expect RMB to become one of the top global currencies in time

than having to buy or sell goods and services in other currencies, which theoretically simplifies the operation of a treasury department managing exposure to China.

But adding any new currency into treasury systems, particularly for large corporations, is a complex and time-consuming process. In the case of China, there is a large burden of documentation required, in addition to the standard re-configuration of systems to ensure the new currency is fully recognised.

"For corporates to reinvest in their treasury and downstream systems to take in a new currency is a big lift and can involve a development cycle lasting up to eight months. We estimate that CNH will grow over the next year to overshadow CAD and CHF trading, rising further to compete with AUD around 2017. Our forecasting is heavily influenced by what we call 'lead lag'; there is a lead in terms of the ambition, but a lag in terms of the work required to take the currency on," says Luke Waddington, co-head of electronic markets for fixed income at BNP Paribas.

Luke Waddington

Waddington, who has played a lead role in the development of BNP Paribas' electronic platforms in recent years, including both the Cortex and Centric portals, recently relocated to Hong Kong to grow the bank's electronic footprint in the region. A priority for corporates, he says, is being able to control capital flows globally from a central treasury, which is made possible by the internationalisation of RMB. "Multinationals usually want the ability to manage flows across their whole group and move them according to the specific needs they have. That means if a subsidiary needs capital, it can source it centrally without having to go to a third party for a loan. That kind of cash pooling is ingrained in corporate workflows and being able to do it with RMB is real progress," says Waddington.

"With RMB, the technology is already there to support the growing currency and it is just a case of expanding it as necessary. That's a huge advantage for everyone,"

INVESTOR OPPORTUNITIES

For investors looking to tap into the emergence of offshore renminbi, the opportunities are somewhat different as it is less about hedging exposures and simplifying operations, and more about capturing yield. Conscious of the need to allow its currency to trade more freely, the People's Bank of China (PBoC) has steadily widened the range in which it will allow RMB to trade against the US dollar. In March 2014, it doubled that band, effectively allowing the currency to rise or fall by 2% above or below a daily benchmark rate.

As renminbi has exhibited greater two-way volatility this year than previously, with a 3.5% fall against the US dollar between late February and early May, many market participants believe the currency has started to come of age in the eyes of investors. A steady appreciation lasting many years may have given some certainty over the direction of the currency, but the reversal opened the door to more investors.

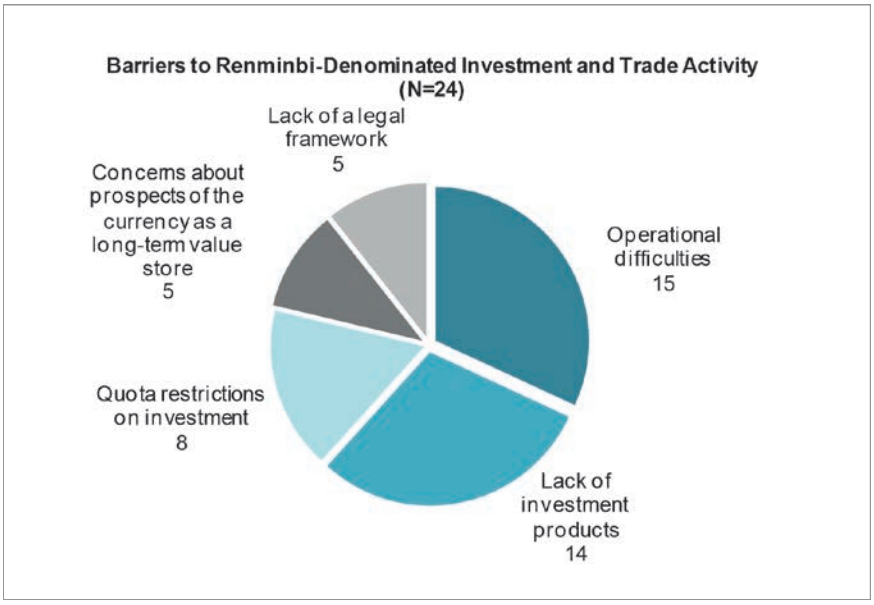
"We had warned a lot of our clients to consider the possibility of two-way volatility because there had been a perception that renminbi would forever appreciate, but the move this year took out a lot of the over-speculation. It is a positive development for the currency and for product depth, because the possibility that the currency will move up and down encourages the use of FX options," says Bernard Yeung, head of emerging markets trading Asia at Commerzbank.

The widening of the trading band is not the only way that Chinese authorities have sought to make RMB products more attractive to international investors. The Qualified Foreign Institutional Investor (QFII) and RMB Qualified Foreign Institutional Investor (RQFII) schemes have also been instrumental in opening up the market to the international investment community.

QFII allows foreign investors to bring US dollars into China, convert them into RMB and then invest the capital, while RQFII, which was launched in late 2011, allows for RMB accumulated offshore to be invested back into China. The RQFII scheme was intended to bolster China's equity and bond markets, creating greater stability in the system by making it less reliant on domestic retail investors. Initially introduced in Hong Kong with a quota cap of RMB 20 billion, it has since been expanded several times and extended to international centres including Taipei, London and Singapore.

The total RQFII quota had risen to RMB 640 billion earlier this year, while the QFII scheme has grown from an initial quota of $4 billion in 2003 to $150 billion in 2013, according to data from China's State Administration of Foreign Exchange. Although RQFII is about attracting investors to the onshore market, its success has also fuelled the growth of the offshore market as investors are required to buy CNH to access RQFII, says BBH's Lin.

"While there is no CNH equity market as such, the RQFII scheme allows global investors access to onshore equity markets. As China continues to expand the scheme, it will increase RMB currency liquidity by increasing the supply of Chinese securities to overseas investors. This quota expansion will continue to expand the range of investment opportunities for global investors, generating increased demand for access to the CNH market," Lin explains.



Source: Aite Group survey of 24 firms active in the Chinese market, Q1 and Q2 2014

Respondent Views on Barriers to Renminbi as an Investment and Trade Currency

CENTRES COMPETE

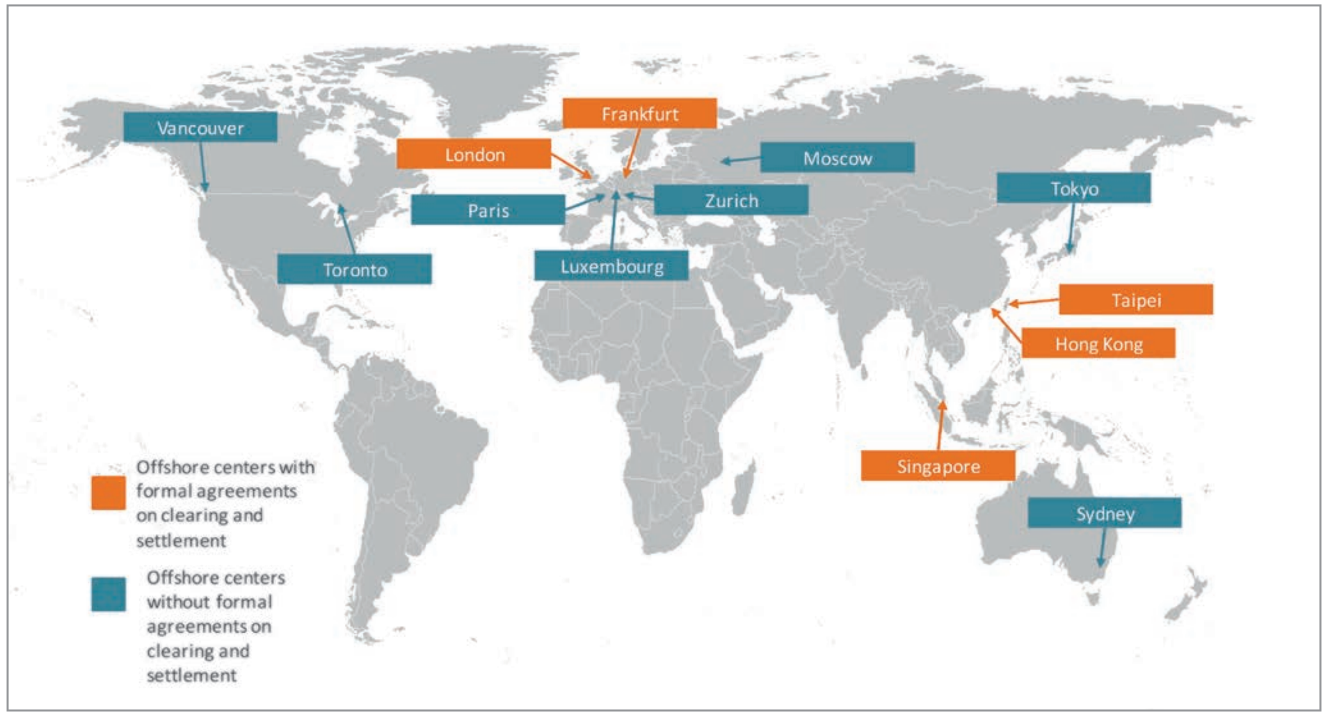
As the CNH market has developed, there has been a steady intensification of competition between a number of Asian and European financial centres to become the offshore centre of choice for the currency. While that rivalry has been led by Hong Kong, Singapore and London, other centres vying for position include Taipei, Seoul, Frankfurt and Luxembourg.

Hong Kong has played a fundamental role in the liberalisation of renminbi so far, having been deeply involved in the development of China's financial market for several decades. It became a testing ground for many of the reforms enacted by China and also led the development of the RQFII scheme from concept to reality.

But even Hong Kong's regulators recognise that other centres are emerging. "We do not consider that Hong Kong has the sole, imperative right to develop offshore RMB business. The RMB story is not just a Hong Kong story. In fact, it is not even just a China story. It is a global story. Competition has always been the key driver for innovation and growth," said Alexa Lam, deputy

Jim Kwiatkowski

"Regulations are driving transparency and pushing competitive pricing, which is enabled with electronic trading. Thomson Reuters e-trading solutions allow participants to easily discover the best price available to them for any trade from their available counterparties."



Source: Aite Group (correct as of April 2014)

Current Offshore Renminbi Centers

chief executive of the Securities and Futures Commission of Hong Kong, speaking at an industry conference in Singapore in March.

Outside Hong Kong, Singapore and London have been most active in promoting themselves as centres of choice for renminbi business, largely on the basis of the existing FX markets in both locations. In London, a high-profile initiative backed by the UK government and many of the largest banks was kicked off in 2012, while in Singapore, ICBC was named by the PBoC as a local clearing bank for RMB in February 2013. It took until June this year for the China Construction Bank to be appointed as the RMB clearing bank in London, at the same time as the Bank of China was named RMB clearing bank in Frankfurt.

"Each offshore RMB centre came into existence on the back of the unique market conditions and trade relationships with China, and each will continue to thrive in its own right. Although Hong Kong retains its dominance among offshore RMB hubs, with a 61% share of CNH trading, the last two years have seen that share decline while the traditional FX centres of London and Singapore have increased their share from about 20% two years ago to more than 30% today. As the market internationalises further, the share of London and Singapore will continue to increase," says Gostick of Thomson Reuters.

The emergence of Frankfurt as a potential western centre for RMB business came as a surprise to those that had expected London to enjoy an easy passage to become the leading centre, given the size of its FX market. But when the PBoC signed a memorandum of understanding with the Bundesbank on March 28 to establish clearing and settlement arrangements for RMB payments in Frankfurt, just days before signing a similar agreement with the Bank of England on March 31, it was seen as a victory for Frankfurt.

"It came as quite a surprise when Frankfurt was named as a renminbi hub before London because the overriding opinion up until then was that any hub needed to be one of the global financial market centres. But what we have now learnt is that for China it is very important to be where the real flow is and it's not just about product experience and derivatives trading," says Stefanie Holtze-Jen, head of FX sales, Asia at Commerzbank.

Darryl Hooker

"There are many second- and third-tier banks that will only trade CLS-eligible currencies, so bringing CNH into CLS would fling the doors wide open to greater participation,"

But both London and Frankfurt are currently trailing behind Singapore, according to SWIFT's RMB Tracker, which provides monthly reports on the progress of RMB internationalisation. In its report for June 2014, it ranked Singapore as the top offshore centre, according to the value of payments sent and received, followed by the UK and the US (the report excludes China and Hong Kong). RMB activity in the North American timezone is naturally less than in Europe and Asia, but some participants believe the competition between centres will become less relevant in the long term.

"There seem to be a large number of centres competing against each other at the moment, but if the currency really internationalises properly, trading will gravitate towards the larger centres, just as all the big currencies do today. RMB flow in the US is fairly slow at the moment but there is an appetite for liquid products in the New York market and I think it will become much bigger there," says Hooker of EBS.

ELECTRONIC TRADING

Inherent within the growth of CNH trading is the increased electronic trading of the currency, and it is for that reason that many providers of both single-dealer platforms and multi-dealer platforms have dedicated substantial resources to ensuring their systems are ready to capitalise on the new market. And while the emergence of new currencies in history might not have had the support of electronic trading platforms, renminbi is at an advantage in that respect.

"If you take the introduction of the euro as an example, e-commerce was developing behind that and had to catch up with it later on. But with RMB, the technology is already there to support the growing currency and it is just a case of expanding it as necessary. That's a huge advantage for everyone," says Waddington of BNP Paribas.

Others see the evolution of electronic trading as a key part of the liberalisation process as Chinese

Is it the *Yuan (元)* or is it the *Renminbi (人民币)*?

Reading any articles or watching news on the Chinese currency, one would notice the seemingly interchangeable use of the *yuan* and *renminbi*. So is there a difference?

Renminbi (人民币), which means the "people's currency" in Chinese, is the official name of the currency of the People's Republic of China. The main unit of the Chinese currency is the *yuan (元)* – please see chart below. So what's causing the confusion?

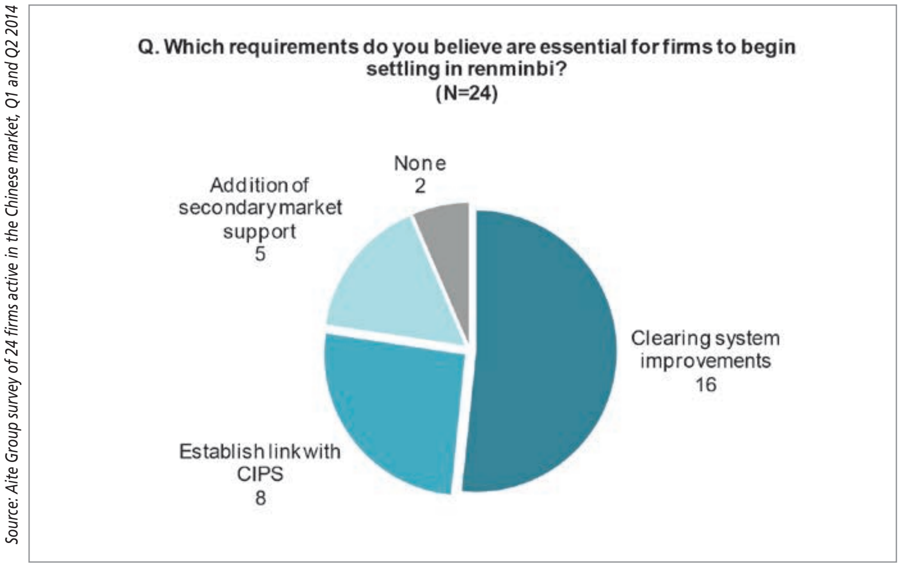
Country	China	USA	UK
Name of currency	*Renminbi*	*United States Dollar*	*Pound Sterling*
Unit of currency	Yuan	Dollar	Pound
Generic short form	Yuan, RMB	USD, US$	GBP, Stg
ISO code	CNY, CNH (1)	USD	GBP
Common sign	¥	$	£

(1) The term CNH was introduced to differentiate between the RMB traded offshore from that traded onshore, CNY. The industry has labelled the offshore pool with a pseudo currency code – CNH – to distinguish it from the onshore pool – CNY. Although not an official ISO currency code, CNH was created by the front office for dealers to indicate FX trades for offshore RMB because it has a different spot rate and yield curves than for onshore CNY. CNH is not an ISO 4217 currency code (SWIFT messages use only the ISO 4217 currency codes). Firms use the code CNH for offshore CNY that is being passed from the front office. Once the code CNH is passed to the middle or at times the back office, this non-ISO currency code must be translated to CNY for settlement. Market practice uses CNY as the ISO currency code with the addition of structured code words to indicate offshore CNY. CNH is widely used as the name for the global offshore RMB market, which originated in Hong Kong.

In the Chinese language, "*yuan*" is a commonly used term for a unit of currency for many currencies – just as "*dollar*" in the English language is a commonly used term for a unit of currency for many currencies. Thus, in circumstances where it is understood which currency one is referring to, ¥1mn (be it CNY or JPY) or $1mn (be it USD, AUD, SGD, etc) is enunciated simply as "*one million yuan (一百万元)*". Officially, the USD in the Chinese language is "*mei yuan (美元)*" and JPY is "*ri yuan (日元)*". In circumstances where it is necessary to distinguish which "*yuan*" is being referred to, one would quote, for example:
"*one million yuan renminbi (一百万元人民币)*" to mean CNY 1mn,
"*one million mei yuan (一百万美元)*" to mean USD 1mn, or
"*one million ri yuan (一百万日元)*" to mean JPY 1mn.
Since both "*one million yuan*" and "*one million yuan renminbi*" invariably mean the same to non-Chinese speakers, it is not surprising that "*yuan*" and "*renminbi*" could be confused as interchangeable terms.

As the offshore RMB Market outside Hong Kong continues to grow, some feel the "H" in CNH perhaps better stand for "*haiwai (海外)*" - which means "offshore" in Chinese.

Source: ASIFMA, Standard Chartered Bank and Thomson Reuters



Connectivity and Infrastructure Requirements for Renminbi Support

authorities create a global network of offshore clearing banks and swap lines with central banks.

"Regulations are driving transparency and pushing competitive pricing, which is enabled with electronic trading. As the primary market for interbank trading and one of the largest independent sources for Dealer-to-Customer electronic trading in China, our e-commerce solutions covering price making, price distribution, liquidity connectivity, auto-hedging and aggregation enable participants to easily discover the best price available to them for any trade from their available counterparties. Once counterparties have established credit limits with each other, settlement risk remains a concern," says Kwiatkowski of Thomson Reuters.

SETTLEMENT CONCERNS

The elimination of settlement risk associated with renminbi trading is a concern shared by other platform operators as well. Widely recognised as the largest risk in the FX market due to the large amounts of cash that must change hands on a daily basis, settlement risk is effectively mitigated by CLS in 17 major currencies. But those currencies don't yet include renminbi, or a number of other rapidly growing currencies such as the Russian ruble.

CLS has long recognised the addition of renminbi to its system to be a priority, and last year it opened an office in Hong Kong to accelerate the process, as well as focusing on other currencies and institutions across Asia. But adding a currency to CLS can take many years and requires the full support of the central bank and government, often necessitating changes to the legal framework.

"There are many second- and third-tier banks that will only trade CLS-eligible currencies, so bringing CNH into CLS would fling the doors wide open to greater participation. The process of adding a currency can take up to three years, but the beauty is that it will be progressed by the Hong Kong Monetary Authority, which led the process of bringing in the Hong Kong dollar so they fully understand the criteria that need to be met," says Hooker.

One obvious stumbling block that must be overcome before the currency can be added to CLS is the launch of a real-time gross settlement system. While there have been moves by the PBoC to create such a system, known as the China International Payment System (CIPS), it has not yet come to fruition.

"There have been many developments in the internationalisation of RMB but the completion of CIPS and CLS eligibility will really be the game changer. The speed at which the currency is growing opens it up to more settlement risk every day, so bringing it into CLS would be a very positive development," Hooker adds.

PATH TO THE TOP

As to what the future holds, the direction of travel is very clear and most expect RMB to become one of the top global currencies in time, but the speed at which that happens will continue to be controlled by the PBoC and other authorities in China and Hong Kong.

"Liberalising too quickly could be detrimental to the Chinese economy because the market is not yet sophisticated enough to handle the inflows and outflows of funds. The ideal scenario is to build up the offshore market slowly to mimic the onshore market," says Commerzbank's Yeung.

As that process continues gradually, many participants expect convergence between the onshore and offshore markets, with a continuing increase in liquidity offshore. That will certainly be a positive development for CNH, although volume in the offshore NDF market is unlikely to rise as the deliverable market grows.

"Each of these markets has its own demand and supply dynamics, which has resulted in three separate, but related, markets with differentiated FX and interest rates and securities pricing. As capital controls ease and linkages grow, the level of difficulty in making cross-border transfers will drop, resulting in offshore onshore convergence," says Gostick of Thomson Reuters.