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Addressing Credit Crunch in China: Liquidity Management Alternatives

The tightening of monetary conditions in recent months has made liquidity management more challenging for US companies doing business in China.

To moderate economic growth and keep it in line with government targets, as well as to combat inflation, Chinese regulators have sought to control the significant rise of investment in China, particularly capital expenditures. The People's Bank of China has imposed tighter controls on how much banks can lend in the local currency, the yuan (CNY), and raised the reserve ratio for all banks to 16.5%.

As a result, US companies that need to borrow in CNY to support their local operations and/or expand their local business in China may find it more challenging and costly to obtain financing from banks. They need to optimize their cash management and working capital to minimize the liquidity impact from higher borrowing costs on their businesses.

For companies reassessing their treasury operations, especially multinationals with an extensive presence in China, here are some strategies that may help streamline liquidity management practices:

- ***Consolidate banking accounts and relationships in China.*** This can offer a couple of important advantages. First, because Chinese regulators have placed limits on the volume of available CNY assets, banks will naturally support core relationship clients first when it comes to meeting financing needs.

  Second, consolidating bank accounts and adopting appropriate liquidity management tools enable companies to optimize their own available liquidity. Holding funds in different accounts with different banks across China can result in a highly inefficient treasury operation, especially in cases where the amount of cash in each account varies significantly.

- ***Consider entrustment loans as a possible financing alternative.*** Chinese regulations do not allow direct intercompany lending, either between corporate units within China or between units outside of China and those within the country. However, they do allow for a financing vehicle known as an entrustment loan.

An entrustment loan is an indirect lending structure in which companies within a group channel funds to one another with a bank acting as an agent to facilitate the loans.

Companies with excess cash (lenders) can place surplus funds as deposits with a bank (entrust agent) to "lend" to designated companies (borrowers). The bank only acts as an entrust agent and does not assume any credit risk. The structure requires a predetermined amount, tenor and interest rates (negotiable using arm's length principles).

An entrustment loan is a common tool used by US companies to enhance their liquidity management, through optimizing group cash balances and lowering onshore borrowing.

- ***Consider third-party entrustment loans as a higher-yielding short-term investment alternative.*** Third-party entrustment loans are entrust loans between two unrelated companies. The solution provides an alternative for companies that need to borrow but are having difficulty receiving funding support from banks directly through bank loans. Lenders benefit because the rates on these loans are generally higher than deposit rates offered by banks and thus generate a competitive return.

  The structure requires banks to have the expertise, scale and the client base to match the appropriate lenders with the right borrowers, as well as the ability to provide support and facilitate the entire negotiation process. The amounts, tenor and interest rates must all be agreed to up front.

- ***Utilize cash sweeps in China.*** Cash sweeping has become increasingly popular because it enables companies to better manage their liquidity and minimize the impact of ongoing credit curbs in China.

  Cash sweeping must be conducted under the entrustment loan framework, which allows physical movement of funds between concentration and member accounts to achieve "zero balancing" or "target balancing." Member accounts are linked to a concentration account, and the interest rates are negotiable between lender and borrower using arm's length principles.

US companies considering a liquidity management solution that utilizes the entrustment loan framework need to be aware that implementing an entrustment loan can take up to three months, so the sooner you begin discussions with your partner bank, the better.

US firms should review their overall working capital cycles and trade terms to look for ways to maximize their liquidity positions. There are ways companies can reduce overall borrowing needs by improving trade terms. Also, in a tight liquidity market, consider risk mitigation tools to better ensure the quality of receivables and the timeliness of cash flows.