LexisNexis®
RISK SOLUTIONS

BRIEFING

Navigating the impacts of the internationalisation of China's economy

JANUARY 2017

LexisNexis®
RISK SOLUTIONS

BRIEFING

1. Internationalisation of China’s Economy

2. Transparency and Money Transfers

3. Overseas Merger and Acquisition Activity

4. Capturing Emerging Markets in Africa

JANUARY 2017

BRIEFING

Navigating the impacts of the internationalisation of China's economy

As China pushes ahead with the internationalisation of RMB – via the introduction of CIPS (the China International Payment System) in October 2015 and the currency's impending inclusion into the IMF's special drawing rights basket, new issues have mandated the need have full visibility into the flow of capital. The government is clamping down on domestic corruption and illicit currency activity linked to capital flows, but underlying apathy towards corruption remains an issue. Financial institutions wishing to capitalize on the trends toward the global integration of China's economy must work to find a way to successfully navigate a circuitous path that combines internal government expectations with expanding market opportunities.

Chris Foye of LexisNexis® Risk Solutions gives his viewpoint into the current situation, "There are a number of factors in China that should be considered. Firstly, there is significant migration of Chinese nationals to countries like US, Canada and Australia which means more people have international exposure and networks. The increasing internationalisation of China with huge outward investment in Europe and emerging economies along with huge volumes of cross-border trade is another factor in play and there is the relatively recent development of the RMB becoming more internationalised."

Foye continues, "In parallel to the above trends, there is increasing concern about corruption, which has led the government to launch several initiatives. One of those initiatives is to reduce the amount of illicit money flowing out of China. This creates pressure on financial institutions in China and foreign financial institutions with a presence in China to ensure they can effectively screen these capital flows and in particular the originator and beneficiary on payment transactions."

Peter Guy, Editor in chief of Regulation Asia weighs in on the paradox, "The growing international use of RMB in forex, capital markets and trade has created its own domestic dilemma as the Chinese have numerous ways to move their savings and investments outside of China. An effectively open trade account and restrictive capital account have enticed mainland Chinese to use contrived trading activities to efficiently move money offshore. However, even a slightly relaxed capital account in 2014 allowed a torrent of capital to fund diversification and investment purposes."

Tackling the demand for transparency across money transfer activities

Just one month after CIPS went online, authorities said they had cracked an underground bank involved in the illegal transfer of some RMB800 billion (USD123 billion) out of China. A month before CIPS, China's SAFE (State Administration of Foreign Exchange) began looking into companies' foreign exchange purchases in an effort to stem the flow of capital out of the country. While such developments happening in tandem might seem contradictory, the story arc of China's economy continues to bend inexorably towards closer global integration.

"For overseas investment projects, or anything state approved, there is encouragement for Chinese institutions to move outside China," says Augustine Tan, founder and chairman of Hong Kong-based banking consultancy Advantage. "In about two years' time, full liberalisation will take place. And, after the removal of currency controls, some money will leave but eventually it will come back."

For overseas investment projects or anything state approved, there is encouragement for Chinese institutions to move outside China.

—Augustine Tan, Advantage

Until then, illicit money transfers, particularly those related to the anti-corruption campaign, will remain a concern. Asset recovery is important because it instils more confidence in the mainland legal system and can improve the level of foreign investment into China. For institutions both domestic and international, reducing risk begins at a local level. According to a private investigator active in mainland China, it can be a complex issue: "The biggest problem is corruption is being committed by senior level people in collusion with internal managers or external parties. The large number of senior bankers involved in fraud suggests mainland Chinese managers do not fear personal reputation risk," he says.

Furthermore, critics say Xi's anti-corruption campaign is open to factionalism and that the Communist Party has failed to introduce systemic reforms to prevent graft, such as public disclosure of assets. For foreign financial institutions, understanding the local background and culture of staff is the key to avoiding the risk of fraud. In many cases, mainland banks are doing a better job at fraud prevention than their international peers because of this greater understanding, the private investigator notes. To counter fraud in Chinese financial institutions, broad training should be implemented; foreign interests should be mindful that the western style approach of writing-off losses does not resonate.

Illegal money transfers outside China, often of the proceeds of fraud, have become a key issue for international banks doing business in the country and domestic banks with overseas subsidiaries.

The ways of transferring money out of China, whether those funds are legitimately gained or not, are becoming increasingly difficult to track.

For instance, the practice of using a mainland China debit card to purchase an insurance contract abroad, cancelling it and then taking the refunded money as cash, became so prevalent it prompted SAFE to put a USD5,000 limit on UnionPay transactions. Then, in March 2016, mainland Chinese authorities further tightened and strictly enforced restrictions on the use of third party payment providers and electronic payment services by mainland residents to purchase insurance and investment related products.

Peter Guy illustrates the issue with anecdotal evidence, “Mainland Chinese have been flocking to Hong Kong to purchase insurance policies, which typically come with better service support than on the mainland. It offers them a way to bypass controls on the amount of capital they can shift outside of China. Purchases of insurance policies by mainland visitors in Hong Kong reached HKD21.2 billion through September of 2015, following a 64 percent increase in 2014, according to the local insurance regulator.”

Other ways of transferring large sums include adding large sums to stored-value cards and giving them to family and friends who live outside China, or obtaining loans in Hong Kong using a deposit with the same bank’s branch in China as collateral.

Chris Foye observes, “A key component of building a deeper understanding into capital movements is to have robust internal systems to monitor customers and payments as well as effective risk-based internal controls to assess customer risk based on product/account type, where the money is going to and the source of wealth.”

A key component of building a deeper understanding into capital movements is to have robust internal systems and effective risk-based internal controls to assess customer risk.

—Chris Foye, LexisNexis

The private investigator in China further quantifies the problem, “Smurfing, the practice of breaking down large sums of money and using individual trade limits to disguise it, is a big problem in the mainland as it is easy to hide remittances among trade invoices and money transfers.” He continues, “Bulk money laundering also remains a problem where there are large overseas Chinese communities. For example, you can deposit RMB in a bank account in China specified by a ‘broker’. Then cash will be delivered to you – minus a fee – in San Francisco, LA, New York, or Vancouver.”

Having the ability to gain a full view of these networks and the connections between customers and transactions is not only vital for banks to ensure they are not involved in laundering the proceeds of mainland China fraud and corruption, but also for risk management purposes, believes Augustine Tan.

A global institution not only needs to obtain a full overview of clients' relationships with branches in different parts of the world, but at the same time must understand the clients' relationships with other institutions. Chris Foye thinks to make this effectively happen, "This requires a more collaborative effort by financial institutions to share KYC information on individuals. Only by taking this step, can a bank reliably determine the relationship between an individual and other institutions as well as drive greater efficiency which ultimately will allow them to concentrate resources on some of the more complex methods for illicit money transfer."

In Hong Kong and Macau – long established centres for illicit transactions originating from China – there has been increasing scrutiny towards new account openings and flagging of large money transfers. At the same time and conversely, mainland banks are perceived as more lenient.

One head of compliance for an international bank in Hong Kong suggests it can be difficult to find the ultimate beneficiary, "The main issue is the complexity of organisational charts," she says, "There are companies, holding companies and different subsidiaries. According to Hong Kong requirements, we must get owner information, verify that personal information and follow Hong Kong rules even for clients in China."

Augustine Tan expands the idea, "Fintech can be a way of gaining a full view of outstanding exposures on a global basis. Corporate clients such as shipping, mining and oil & gas companies will not have all their exposures to an institution in one place." He continues, "Only a few banks have come to understand the relationships, between clients' exposures to other institutions, and monitor not only what they have from a client, but the client's related capital held with other institutions."

Maximizing the rewards of overseas merger and acquisitions

China is witnessing a decline in domestic M&A due to a focus on restructuring, rather than expansion. Conversely, Chinese companies' appetite for international deals remains strong. International M&A has its own challenges and Chinese organisations should consider several lessons learned when mitigating risk. In addition to the internationalisation of its currency, overseas M&A looks set to be an increasingly important part of the globalisation of China's economy. Here, capital outflows are positively encouraged.

This is due to a range of domestic constraints, according to investment banker Mr. Zhang, not least asset bubbles which are forcing firms to restructure rather than expand, "The P2P market, for example, had been extremely hot, so there was a surge in M&A. But right now, Chinese enterprises are focused on restructuring," he says. "There will be fewer mainland China opportunities, but there are still plenty overseas."

That is not to say there is no deal activity within China. According to Mr. Shel, an M&A analyst, resource constraints are fostering some firms to consider leveraged buy outs rather than pure mergers or acquisitions, and private equity buyout funds are another trending acquisition model.

Although the Chinese government has recognised the difficulties in domestic M&A, he adds: “Relaxing regulations, easing administrative examination and approval of deals, and accelerating the deal process itself, it does not appear to have been sufficient to counteract resource constraints.”

Dr. Cai, professor at Zhongnan University of Economics and Law, gives more details of this transition,

“China’s economic growth has slowed, and traditional enterprises are undergoing a difficult transition, while technology, media and telecommunications (TMT) and other emerging industries are developing rapidly.” He continues, “Against the backdrop of reform of state-owned enterprises towards mixed ownership, SOE acquisitions have been extremely active. Renminbi depreciation has also led to enterprises focusing on overseas investment, and the government is encouraging globalisation as the US did in the 1990s.”

Overseas M&A therefore looks set to be an increasingly important part of the globalisation of China’s economy, and is one area in which the government is encouraging capital outflows - particularly via the Shanghai Free-Trade Zone and its equivalent in Qinghai, which are seen as a substantial advantage to firms in completing deals. To be successful, mainland institutions will need to be familiar with overseas processes.

In terms of geographies, Mr. Lan, a senior investment bank executive, believes Europe will be a popular destination for outbound deals, “Europe will be the main destination for outbound mergers, particularly Germany, UK, France and Italy.” Lan observes, “This will create issues such as dealing with overseas law, particularly anti-monopoly measures,” he adds, citing the failure of Bright Foods to buy 50 percent of France’s Yoplait in 2011, “This was seen to have been unsuccessful, at least partly, due to opposition from the French government.” Finally, Lan concludes, “Some European enterprises have still not recovered from the financial crisis and resulting economic instability. This creates a good chance for mainland enterprises to invest. Africa also presents a good opportunity for long-term investment.”

Strengthening acquisition decisions will deeper due diligence

In the short-term, information asymmetry will be a barrier to success. Longer term, Chinese organisations should consider the availability of industrial capital and private equity funds to feed investment. In terms of sector, according to Mr. Song, a Hong Kong-based private equity manager, science and technology companies will be the main targets of outbound M&A over the rest of 2016. He cites Shenzhen Deren Electronic Co’s EUR57 million (USD64 million) purchase of a stake in Italian automotive electronics firm Meta. Denny Chan, senior business development and M&A manager at SABIC, notes that the chemicals sector is a particularly active area of M&A, as well as corporate restructurings and other reorganisations, often regardless of economic conditions. Meanwhile, companies in Chinese industries suffering from overcapacity could start to seek deals in emerging economies, according to Mr. Song. Here too, issues of gaining a full view of potential targets, and their business environment, is a key task.

One of the main shortages is a lack of understanding of an M&A target's situation and local conditions, which has been a problem for Chinese institutions doing deals overseas. It can create problems at any stage of a deal, according to Mr. Lan, including the departure of key local staff after completion if a firm does not fully understand an acquired company's culture. "Secondly, there is an issue of how to estimate the acquisition price. Normally, when news of a deal enters the market it has a huge impact on continuing negotiations," he adds.

For Mr. Song, the three major requirements in conducting due diligence on an acquisition are understanding the market cycle of its industry, fully investigating its claimed assets and understanding the legal environment in which it operates.

Chris Foye stresses the important of due diligence not only on the front end of the deal but throughout the lifecycle of the business relationship, "For Chinese companies expanding abroad, there are increased regulatory obligations and in particular a need to have an effective screening programme in place for sanctions and PEPs."

For Chinese companies expanding abroad, there are increased regulatory obligations and in particular a need to have an effective screening programme in place for sanctions and PEPs.

—Chris Foye, LexisNexis

"A lack of clear, effective management is the main reason for M&A failure," confirms Dr. Cai. "The Chinalco-Rio Tinto, Ping An-Fortis and CNOOC-Unocal deals show this example. Even after successful completion, a company might not achieve its original objective if there is a lack of integration planning or weak implementation." This highlights the importance of due diligence, he believes, particularly as companies have an ever-shorter time to build capacity after they make bids. "Normally, when Chinese enterprises have started to seek overseas M&A, they have struggled to build a professional due diligence and consulting team in a short time, which puts them at an advantage to the rest of the market. The sooner the process starts, the sooner it can be improved."

For Chan at SABIC, this is as true for Chinese companies conducting M&A at home as it is for those seeking deals abroad. "One of the big gaps is in early identification of 'deal breakers', which often get found out only when the company makes further enquiries," he says. "Risks in business model, legal environment, human resources, and liabilities all have to be found, controlled and mitigated, no matter the size of the enterprise."

Capturing the economic advantages of Africa's emerging markets

Sino-African connections will continue to expand. In spite of years of investment into the region and a renewed appetite linked to the RMB's development, Chinese companies still face uncertainty and risk. China's interests in Africa have largely been fuelled by natural resources and commodities. In light of weaker economic conditions, there have been questions raised over the future of Sino-African ventures.

According to a regional revenue manager, there are four key risks for Chinese corporations doing business in Africa: political and internal instability; regulatory loopholes and uncertainty; intervention by third countries such as the US; and the threat of terrorism.

"First, it is important to understand the risks I just mentioned. Second, enterprises have to establish risk prevention strategies taking into account the political, social environment and economic environment. Third, enterprises should look to hire some local, experienced talent to management positions," he says.

This is unlikely to be achieved without government support, however, particularly in sectors such as energy: "On the basis of risk analysis, the Chinese government should look to create a corresponding policy to help Chinese enterprises in the region."

In terms of push factors, China's demand for oil continues to grow, in large part due to rising levels of vehicle ownership in the country. On the pull side, South Africa has welcomed Chinese foreign direct investment, and Africa more widely remains a major importer of Chinese goods. "The internationalisation of the RMB can be a shortcut to helping African countries reduce import costs, and promote international trade growth," the regional revenue manager says, continuing, "China is already helping African countries build infrastructure networks, which in turn boost industrialisation and the development of local manufacturing industry."

From an enterprise perspective, according to investment banker Mr. Zhang, Chinese companies suffer from a lack of knowledge about doing business or making deals in Africa, "One of the biggest problems is internal talent. Most companies' M&A personnel have lots of experience in the mainland market but that doesn't mean they can handle overseas M&A issues, especially in Africa." He continues to explain, "When doing overseas M&A, most enterprises will hire third parties, and there is an increasing number of foreign talent resident in China who can help. But when it comes to Africa, so far there are few people at Chinese enterprises with any experience of doing deals there."

As the internationalisation of China's economy moves forward, accurate due diligence takes a center role for doing business both within the country and to support successful merger and acquisition activity abroad. Understanding the risk profile, key relationships and interconnections of the people and businesses behind capital transfers is an essential foundational element for successfully conducting business in China. Mergers and acquisitions present a two-fold due diligence challenge. At the front end, you must gather as much reconnaissance as possible to get the advantage of truly knowing your acquisition target and building a complete understanding of their business model, internal infrastructure and operations. Post-acquisition, you need to seamlessly navigate the country-specific compliance and regulatory environment to avoid operational delays and unnecessary risk exposure.

LexisNexis can help design an integrated risk-based due diligence workflow that enables your business to successfully navigate the opportunities and challenges created by the internationalisation of China's economy. We deliver the powerful combination of leading intelligence and proven analytics to help your company amplify risk visibility, avoid compliance process delays, reduce costs and concentrate on capturing more market share, both inside and outside of mainland China.

Our solutions are designed to deliver a synthesized picture of your customer and the risk they may, or may not, pose to facilitate faster, more well-informed decisions across the entire customer lifecycle. We can help your business truly know your customer and understand the intricacies of their critical relationships and connections. Our solutions highlight and help identify potential AML risk before it impacts your business. By leveraging tools from LexisNexis, you can implement a comprehensive compliance workflow without interrupting your core business.

Contact us to see how we can help you balance the goals of protecting your business and maintaining profitable operations.

For more information
www.lexisnexis.com/risk/apac
Toll Free China 400.120.2848

References

http://www.ft.com/intl/cms/s/0/83387282-8f60-11e5-8be4-3506bf20cc2b.html#axzz3z7pI7EwS

http://www.forbes.com/2007/08/07/shenzhen-underground-bank-markets-equity-cx_jc_0807markets03.html

http://www.china.org.cn/china/2015-04/16/content_35343062.htm

LexisNexis® RISK SOLUTIONS

About LexisNexis Risk Solutions

LexisNexis Risk Solutions is a leader in providing essential information that helps customers across industries and government predict, assess and manage risk. Combining cutting-edge technology, unique data and advanced analytics, LexisNexis Risk Solutions provides products and services that address evolving client needs in the risk sector while upholding the highest standards of security and privacy. LexisNexis Risk Solutions is part of RELX Group plc, a world-leading provider of information solutions for professional customers across industries.