

BRIEFING

Navigating the impacts of the internationalisation of China's economy

Part 1

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Recent economic actions in China suggest a movement toward an economy characterized by more fluidity and liberty across the global marketplace. Financial institutions trying to take advantage of this trend must traverse a fragile compliance route marked by incongruities and conflicting requirements. In part one of this briefing, we explore how truly open China's economy has become and highlight the critical role adequate and comprehensive due diligence play in protecting your business against compliance missteps.

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."

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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.”

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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.”

As the internationalisation of China’s economy moves forward, accurate due diligence takes a center role. 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. 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.

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

For more information
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