

New Regime on Cross Border Financing in China

Speed read

The People's Bank of China (**PBOC**) issued the *Notice on Nationwide Implementation of Macro Prudential Management of Cross Border Financing* (《中国人民银行关于在全国范围内实施全口径跨境融资宏观审慎管理的通知》) (the **Notice**) which took effect on 3 May 2016 and fundamentally changes the regulation on the incurrence of cross border debt by PRC Enterprises.

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1. New Regime

The Notice introduces a new regime (the **New Regime**) to determine the amount of foreign debt a PRC incorporated entity may borrow based on its net asset value/capital and outstanding borrowings, in each case on a risk weighted basis. The New Regime is fundamentally different from the previous regime where different methods administered by different authorities apply to determine the amount of foreign debt a domestic company with no foreign ownership or a foreign investment enterprise with less than 25% foreign ownership (each a **Domestic Company**) or a foreign investment enterprise with at least 25% foreign ownership (an **FIE**, and each a **PRC Enterprise**) may borrow.

This is a new paradigm for the PRC to control foreign debt. In this bulletin, we will first look at the key changes introduced by the Notice and how the maximum amount of foreign debt that may be assumed by PRC Enterprises is determined under the New Regime. We will then discuss the practical implications of the New Regime.

The text of the Notice in Chinese is available at:

<http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/3056127/index.html>

2. Key changes

1. EXISTING REGIME BASED ON PRE-APPROVED QUOTA OR HEADROOM IS TO BE REPLACED

Before the introduction of the New Regime, save for certain eligible enterprises incorporated in a free trade zone that is already subject to a pilot scheme similar to the New Regime implemented in January 2016 (for details, please see our client bulletin dated 27 January 2016), a Domestic Company is required to obtain an annual quota from the National Development and Reform Commission (the **NDRC**) in order to incur any foreign debt. In the case of an FIE, the amount of foreign debt it could incur would be limited to the amount of its total investment amount less any registered capital, typically referred to as the “headroom”.

Under the New Regime, slightly different methods of determination apply to corporates and financial institutions, but significantly the same rules under the New Regime apply in the same manner for a Domestic Company and an FIE (except for real estate companies and government financing platforms, which are expressly excluded from the New Regime). For real estate companies and government financing platforms, the existing foreign debt regulatory regime continues to apply.

For other Domestic Enterprises, the pre-approval by way of foreign debt quota is replaced by post-event filing. For an FIE, it may elect to adopt the New Regime or to continue to adopt the previous regime during a transition period. The length of the transition period and the transitional arrangement will be set out in a further notice to be issued.

2. DIFFERENCES IN RMB AND FOREIGN CURRENCY DENOMINATED FOREIGN DEBT ELIMINATED

Under the previous regime, there was no clarity as to whether foreign debt denominated in RMB would be counted towards a foreign debt annual quota or headroom. There was also confusion on whether PBOC or the State Administration of Foreign Exchange (**SAFE**) had responsibility for monitoring the incurrence of foreign debt denominated in RMB – while PBOC asserted that RMB

cross border financings were under its sole management, there was uncertainty as to whether or not any RMB cross border financings would also need to be filed with and monitored by SAFE.

The New Regime removes this uncertainty. As illustrated in section 2 below, the formula through which the amount of foreign debt a PRC Enterprise may borrow is to be calculated based in RMB. If that PRC Enterprise has any foreign currency denominated foreign debt, this will be converted into RMB-equivalent.

The Notice also clearly sets out the different roles PBOC and SAFE play in regulating cross border financings, as follows:

	PBOC	SAFE
Subject under administration	27 banks (see Annex I below)	<ul style="list-style-type: none"> All corporates other than real estate companies and government financing platforms (and irrespective of whether they are Domestic Companies or FIEs) Financial Institutions other than the 27 banks under the administration of PBOC
Role	<ul style="list-style-type: none"> Administering the filing of foreign debt incurred by the 27 banks Monitoring the macro-economic environment and adjusting: <ul style="list-style-type: none"> (1) the risk ratios in the formula to determine the foreign debt (2) the list of excluded types of cross border financings 	Administering the filing of cross border financings incurred by the PRC Enterprises under its administration

3. FILING AND REPORTING REQUIREMENTS

Any foreign debt incurred by a PRC Enterprise will need to be filed and reported under the New Regime. A corporate borrower is required to file with SAFE after signing a cross border financing agreement and in any event at least three business days prior to drawdown of the foreign debt. A financial institution borrower is required to make an initial filing with PBOC or SAFE regarding their

foreign debt limit and the remaining foreign debt quota, and then file with (as applicable) PBOC or SAFE whenever a cross border financing agreement is signed.

Post-filing, the relevant borrower may update information on its foreign debt (such as any utilisation or repayment made) with PBOC or SAFE. For a corporate borrower, it will have to update information regarding its foreign debt on an annual basis, and if there are any changes to the key terms of the foreign debt, a supplemental filing will need to be made.

3. Determining the foreign debt quota

The mechanism in determining the amount of foreign debt a PRC Enterprise may borrow under the New Regime is very different from the previous regime. Broadly speaking, at the time of incurrence of a foreign debt, the aggregate outstanding amount of foreign debt incurred or to be incurred by a PRC Enterprise on a risk weighted basis (the **Risk Weighted Balance**) shall not exceed the applicable foreign debt limit of that PRC Enterprise determined by reference to its net assets (in case of corporate) or capital (in case of financial institution), in each case on a risk weighted basis (the **Risk Weighted Limit**). The mechanism is summarised in the table below.

For corporates

Risk Weighted Limit

Net assets
 x 1 (financing leverage ratio)
 x 1 (macro prudential ratio)

≥

Risk Weighted Balance

Outstanding amount of all foreign debt denominated in RMB with a tenor less than 1 year (inclusive) x 1.5 (tenor risk ratio) x 1 (class risk ratio)

+

Outstanding amount of all foreign debt denominated in RMB with a tenor more than 1 year (exclusive) x 1 (tenor risk ratio) x 1 (class risk ratio)

+

RMB equivalent of the outstanding amount of all foreign debt denominated in foreign currency (other than any trade finance) with a tenor less than 1 year (inclusive) x 1.5 (tenor risk ratio) x 1 (class risk ratio)

+

RMB equivalent of the outstanding amount of all foreign debt denominated in foreign currency (other than any trade finance) with a tenor more than 1 year (exclusive) x 1 (tenor risk ratio) x 1 (class risk ratio)

+

RMB equivalent of the outstanding amount of all foreign debt denominated in foreign currency (other than any trade finance) x 0.5 (exchange rate risk ratio)

+

RMB equivalent of the outstanding amount of all foreign trade finance denominated in foreign currency x 1 (tenor risk ratio) x 0.2 (class risk ratio)

+

Outstanding amount (or RMB equivalent amount if it is denominated in foreign currency) of all foreign security constituting *Nei Bao Wai Dai* provided by such corporate, determined in the same manner as the boxes above

+

The amount of the proposed cross border financing (or its RMB equivalent if it is in foreign currency), determined in the same manner as the boxes above

For financial institutions**Risk Weighted Limit**

Capital
 x 1 (financing leverage ratio in case for a non-bank financial institution) **or**
 0.8 (financing leverage ratio in case for a

≥

Risk Weighted Balance

Outstanding amount of all foreign debt denominated in RMB with a tenor less than 1 year (inclusive) x 1.5 (tenor risk ratio) x 1 (class risk ratio)

+

Outstanding amount of all foreign debt denominated in RMB with a tenor more than 1 year (exclusive) x 1 (tenor risk ratio) x 1 (class risk ratio)

+

RMB equivalent of the outstanding amount of all foreign debt denominated in foreign currency (other than any trade finance) with a tenor less than 1 year (inclusive) x 1.5 (tenor risk ratio) x 1 (class risk ratio)

+

RMB equivalent of the outstanding amount of all foreign debt denominated in foreign currency (other than any trade finance) with a tenor more than 1 year (exclusive) x 1 (tenor risk ratio) x 1 (class risk ratio)

+

RMB equivalent of the outstanding amount of all foreign debt denominated in foreign currency (other than any trade finance) x 0.5 (exchange rate risk ratio)

+

RMB equivalent of the outstanding amount of all foreign trade finance denominated in foreign currency) x 1 (tenor risk ratio) x 0.2 (class risk ratio) [could be less relevant for a financial institution]

+

The fair value of the amount (or RMB equivalent amount if it is denominated in foreign currency) of all foreign security constituting *Nei Bao Wai Dai* and cross border hedging instruments entered into by such financial institution, determined in the same manner as the boxes above.

+

The amount of the proposed cross border financing (or its RMB equivalent if it is in foreign currency) determined in the same manner as the boxes above

Notes:

1. Depending on the macro-economic environment, PBOC may adjust the weight ascribed to various risk ratios in the formula in order to control the amount of foreign debt that PRC Enterprises may borrow. As such, the weight currently ascribed to various ratios used in the formula (most of them are 1 currently) may change from time to time.
2. The following cross border financing transactions are expressly excluded in calculating the Risk Weighted Balance:
 - i. *passive RMB debts*: including (a) RMB debts incurred by a corporate or financial institution resulting from an offshore entity investing in the onshore bond markets (i.e. holding bonds issued by the corporate/financial institutions) and (b) RMB deposits placed by an offshore entity with a financial institution;
 - ii. *trade credits and RMB denominated trade finance*: (a) all trade credits of a corporate arising under a genuine cross border transaction (such as any advance payment or payables); (b) all RMB denominated trade finance made available to a corporate by offshore financial institutions; and (c) RMB denominated trade financing arising in connection with clearing of cross border trade by a PRC financial institution;
 - iii. *intra-company payables*: any cross border intra-company payable owed by a corporate arising in connection with its operations or investment activities legally that has been filed with the relevant authorities;
 - iv. *interbank deposits and intragroup payables by financial institutions*: any deposits taken by a financial institution from its offshore affiliates or any other foreign debts arising from intra-group transactions between a financial institution and its offshore affiliates or branches;
 - v. *panda bonds*: any panda bond proceeds lent by the offshore issuer to its onshore subsidiaries; and
 - vi. *transfer or waiver*: if the proceeds of a cross border financing provided to a corporate or financial institution was used to increase the capital of such corporate or financial institution, or if the debt owed under a cross border financing was waived, the amount that was applied to increase the capital or the amount so waived will be excluded.
3. RMB equivalent will be determined using the exchange rate published by China Foreign Exchange Trading Center (if the relevant foreign currency is so listed) or reference rate published by the China Foreign Exchange Trading Center (if the relevant foreign currency is not so listed) on the drawdown date of financing.

4. Practical issues

As the New Regime is fundamentally different from the previous regime and has only come into effect recently, there are uncertainties as to how it will be implemented in practice. There is also very limited guidance that could be drawn from the pilot scheme implemented in the FTZ for just a few months. We set out below several issues that may need to be further clarified.

1. INCLUSION OF “OFF BALANCE SHEET FINANCING (CONTINGENT LIABILITY)”

The term “off balance sheet financing (contingent liability)” is referred to in the formula to determine foreign debt, but it is not entirely clear what will constitute “off balance sheet financing (contingent liability)” and how it will affect the determination of foreign debt quota.

On one hand, it is expressly mentioned that, in determining the foreign debt quota of a financial institution, such amount will cover any foreign security (*nei bao wai dai*) (i.e. security or guarantee provided by a PRC Enterprise in favour of a non-PRC creditor in respect of an offshore loan) provided by that financial institution or any hedging transaction entered into by it. The notice is however silent on whether “off balance sheet financing (contingent liability)” will be relevant for a corporate borrower and if so how such amount will be determined in the context of a corporate borrower. If the same interpretation that applies in determining such amount for a financial institution will also apply to a corporate, then any foreign security (*nei bao wai dai*) provided by a corporate will also be counted into the formula and therefore consumes such corporate’s foreign debt quota. If this is the case, the New Regime may have the effect of indirectly imposing a cap on the amount of *nei bao wai dai* a PRC corporate is allowed to provide (with reference to its net asset value), which otherwise is not restricted under the current foreign security regime.

A further issue to clarify is that a corporate may provide foreign security in the form of a financial guarantee or an asset security, which are regulated by SAFE in the same manner as *nei bao wai dai*. However, if the amount of any *nei bao wai dai* provided by a corporate will need to be taken into account in determining its foreign debt quota, query if only a *nei bao wai dai* provided in a form of a financial guarantee (and not an asset security) would be relevant as a contingent liability for that corporate borrower.

Another question is that, if the foreign security is provided by a PRC Enterprise in favour of an offshore lender to secure a foreign debt of another PRC Enterprise, whether such foreign security will constitute an off balance sheet financing (contingent liability) of the security provider. On the face of it, the answer may be yes, even though the primary debt being secured is already a foreign debt regulated by the New Regime. It remains to be clarified whether the same foreign debt will be regulated more than one time.

2. HOW VARIOUS AMOUNTS IN THE FORMULA SHOULD BE DETERMINED

Various elements in the formula for determining the foreign debt quota, such as “net assets” and “outstanding amount under foreign debts”, may change from time to time. No guideline is given under the New Rule as to how such amount will be determined for the purpose of determining the foreign debt quota. For example, at a time when a foreign debt filing is made, the amount of “net assets” will be determined with reference to its latest audited financial statement, but is it to be determined on a consolidated or unconsolidated basis? Would any adjustment be required to be made from the relevant line items as shown in the financial statements? What evidence will be required as proof of the outstanding amount under the foreign debts, in particular if a foreign debt has been partially repaid or prepaid? These practical issues will need to be addressed. The Notice mentioned that SAFE will publish detailed implemental rules that may address some of these practical issues.

3. FIE: TO CHOOSE OR NOT TO CHOOSE

FIEs now face the question as to whether or not they should opt to follow the New Regime in determining its foreign debt quota, or continue to follow the existing regime based on headroom. The Notice expressly provides that, during a transition period, an FIE has the right to choose which regime to follow and should file its choice with PBOC and SAFE accordingly. Once the choice is made, it cannot be changed unless with reasonable cause and with the approval of PBOC and SAFE. However, it remains unclear whether, if an FIE does not make a filing with PBOC or SAFE of its election, there is a default position that the existing regime based on headroom will continue to apply. The same transitional arrangement applies to foreign financial institutions.

In any case, while currently different systems may still apply to a Domestic Company and FIE until further notice, one may expect that the systems are set to converge under the New Regime after the transition period. It remains to be seen how FIEs would make their decision during this transition period as the effect could be mixed on an FIE. On the one hand, calculation under the New Regime may more accurately reflect the actual leverage (instead of the previous regime where the long-term debt will permanently consume the headroom) of an FIE as the quota is determined with reference to the amount of actual outstanding foreign debt and current net assets or capital. On the other hand, the New Regime may potentially reduce the amount of foreign debt which may be borrowed by an FIE which has insufficient net asset value (e.g. those engaged in greenfield development may need to rely on the headroom to incur foreign debt for the purpose of developing a project). This may in turn have the effect of limiting the ability of a foreign shareholder of an FIE to manage the capital structure of that FIE by putting in shareholder loans within the headroom, which would be limited by the net asset value of that FIE under the New Regime.

4. CONSEQUENCES OF NOT FILING

The New Rule mentioned that each of PBOC and SAFE will have its own role to monitor the implementation of the new foreign debt regime and to enforce the relevant laws and regulations. If any PRC Enterprise is in breach of the Notice, depending on the seriousness of the breach, PBOC and SAFE will have the power to order rectification actions to be taken, impose penalties in accordance with the relevant laws and regulations or, if the breach is serious, suspend any foreign debt business conducted by a PRC Enterprise.

As such, if no proper filing is made in contravention of the New Rule, the most serious consequence could result in the PRC Enterprise not being able to perform its obligation under the foreign debt. From a lender's perspective, it is therefore essential to ensure that any foreign debt to be made to a PRC Enterprise will be within its foreign debt quota, and that filing will be made as a condition precedent to be satisfied prior to any drawdown being made.

5. LIMITED GUIDANCE ON THE PURPOSE OF FOREIGN DEBT

While the Notice provides for a prescriptive formula in determining the amount of foreign debt a PRC Enterprise could incur, it remains silent on whether there is any requirement or restriction on the purpose of a cross border financing. In such a case, it is expected that any existing limitation on the purpose of cross border financing proceeds should continue to apply – for example, that proceeds from the foreign currency cross border financing cannot be used to refinance an onshore RMB loan, and cross border financing proceeds cannot be invested in the stock markets.

6. INTERACTION WITH NDRC FILING REQUIREMENT

According to the circular promulgated by the **NDRC** on foreign debt registration (国家发展改革委关于推进企业发行外债备案登记制管理改革的通知 (发改外资[2015] 2044号)) (the **NDRC Circular**) on and effective from 14 September 2015, any foreign debt shall be filed with the NDRC and is subject to the nationwide total foreign debt quota decided by the NDRC.

While the Notice clearly sets out the division of labour between PBOC and SAFE, it remains silent on how the New Regime will interact with the NDRC filing requirement arising under the NDRC Circular. Given that the NDRC is at the same level as PBOC in the state hierarchy, the Notice would not have the effect of superseding the filing requirement under the NDRC Circular. The NDRC filing requirement for foreign debt, therefore, will continue to exist in parallel with the New Regime, and hence filing in accordance with the New Regime would not substitute the need for (or introduce any further clarity or the need for) filing with the NDRC.

7. IMPLICATION FOR BOND ISSUANCES BY PRC BANKS AND CORPORATES

A PRC bank is required to obtain prior approval from PBOC to issue RMB bonds in overseas markets under existing PBOC regulations. In connection with the pilot scheme of PBOC governing cross border financings implemented in January 2016, PBOC published FAQs in March 2016 to clarify certain issues relating to the pilot scheme. In the FAQs, PBOC has clarified that where a PRC bank issues bonds overseas, it shall comply with the existing PBOC rules (presumably including prior approval requirements under the rules governing issuance of RMB bonds overseas by PRC banks) and the bond proceeds shall be calculated into the weighted risk balance of the PRC bank. In the absence of further clarification, it is expected that the above position would still apply in the context of the New Regime.

Pursuant to the Notice, PRC banks will need to file and report the relevant information of their bond issuances. However, there is uncertainty as to whether issuances by offshore branches of PRC banks would be subject to the post-filing requirement. It is not clear whether an offshore branch of a PRC bank would be considered as an “offshore entity” or “onshore entity”. We would recommend branches of PRC banks to seek clarification from PBOC if they intend to issue bonds in overseas markets.

For PRC incorporated corporates doing direct issuance offshore, they should note the filing and reporting requirement under the Notice. The practical issue which a PRC corporate may face is the requirement that information relating to the issuance should be filed with SAFE three working days prior to “drawdown date”. Unlike loan financing where the drawdown date may be sometime after the signing of the facility agreement, the issue date of the bonds and the closing date on which the issuer will receive the bonds proceeds will be the same date. It remains to be seen how the timing contemplated under the filing and reporting requirement would apply in the context of a bond issuance by a PRC corporate.

5. Conclusion

The Notice introduces fundamental changes in the regulation of the incurrence of cross border debt by PRC Enterprises, in particular the FIEs. The foreign debt regulatory regime will be streamlined and rationalised with the convergence of the regime for RMB and foreign debt in other currencies, and of the regime for Domestic Companies and FIEs (other than in certain sectors). As it is still early days, it is expected that implementation regulations, further guidance and local PBOC and SAFE practices will be published or further developed to provide more clarity on the actual administration of the New Regime.

Annex 1

LIST OF BANKS UNDER PBOC ADMINISTRATION

1. 国家开发银行China Development Bank
2. 进出口银行Export-Import Bank of China
3. 农业发展银行 Agricultural Development Bank of China
4. 中国工商银行Industrial and Commercial Bank of China
5. 农业银行Agricultural Bank of China
6. 中国银行Bank of China
7. 中国建设银行China Construction Bank
8. 交通银行Bank of Communications
9. 中信银行China CITIC Bank
10. 中国光大银行Everbright Bank
11. 华夏银行Huaxia Bank
12. 中国民生银行China Mingsheng Bank
13. 招商银行China Merchants Bank
14. 兴业银行Industrial Bank
15. 广发银行Guangfa Bank
16. 平安银行Ping An Bank
17. 浦发银行Pudong Development Bank
18. 恒丰银行Hengfeng Bank
19. 浙商银行Zheshang Bank
20. 渤海银行Bohai Bank
21. 中国邮政储蓄银行Postal Savings Bank of China
22. 北京银行Bank of Beijing
23. 上海银行Bank of Shanghai
24. 江苏银行Bank of Jiangsu
25. 汇丰银行（中国）有限公司HSBC Bank (China) Company Limited
26. 花旗银行（中国）有限公司Citibank (China) Limited
27. 渣打银行（中国）有限公司Standard Chartered Bank (China) Limited

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