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Remittance of RMB funds raised offshore: an update on regulatory developments

Accelerated by the increasing use of Renminbi (RMB) in the settlement of cross-border trade, offshore RMB markets, in particular Hong Kong, have developed speedily. The accumulation of offshore RMB has opened another door for cross-border financing. Yet, RMB capital account transactions in China have been strictly monitored and the difficulty in remitting funds raised offshore has remained a key obstacle in developing cross-border RMB financing in China. With recent rapid de-regulation, however, this obstacle is gradually removed as the remittance of RMB funds under certain channels become clear and permissible.

Generally speaking, the channels of remitting cross-border RMB through capital account transactions include the following: capital injection (RMB foreign direct investment), cross-border loan, investment in the interbank market and investment in China's capital market through RMB qualified foreign institutional investors (RQFII). This article discusses the first two main channels for RMB remittance in detail.

At present, PRC authorities are in the process of putting together the formalities and procedures for fund remittance for cross-border RMB financing. According to the People's Bank of China (PBOC), it has approved, on a case-by-case basis in 2010, foreign direct investment invested in RMB amounting to RMB42.7 billion (approximately US$6.7 billion), and 16 cross-border RMB financing transactions amounting to RMB81.4 billion (approximately US$12.7 billion), out of which RMB27.5 billion (approximately US$4.3 billion) in 13 transactions have already been drawn.

In order to better manage the increasing number of applications and promote cross-border use of the RMB, PBOC, the Ministry of Commerce (MOFCOM) and the State Administration of Foreign Exchange (SAFE) have formulated a set of operational rules under the current regulatory regime that could be applied to capital account transactions in RMB. The accumulation of experiences from increasing practices have helped PRC regulators transform the case-by-case approval mechanism into a regular regime that gives more certainty to offshore investors. It is noted that onshore entities other than commercial banks and policy banks are currently still not permitted to issue debt financing instruments denominated in RMB in the offshore market.

The latest regulatory development on RMB remittance took place in October 2011 with the specific issue of a MOFCOM circular on RMB cross-border foreign direct investment and a corresponding PBOC notice on the settlement of RMB funds, which clarified the permissible scale of foreign direct investment denominated in RMB. Please see detailed discussion on this respectively under the sections "Capital Injection" and "Cross-border Loan" below.

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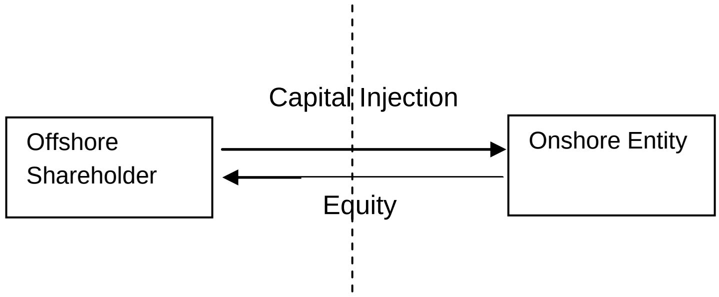
Capital Injection



Previous Regulatory Regime

The most straightforward way to remit RMB funds raised offshore into China is through capital injection. Capital injection as an approach of foreign direct investment is subject to the review and approval of MOFCOM or its local branch. In accordance with an earlier *MOFCOM Circular on Relevant Issues in Foreign Investment Administration* dated 25 February 2011 (MOFCOM Circular), foreign investment in RMB must be approved by MOFCOM at the central level, and the investment currency (i.e. RMB) and amount must be specified in the approval letter issued by MOFCOM.

In accordance with the *Circular of the General Affairs Department of SAFE on Relevant Issues on Regulating the Operational Procedures* of *Cross-border RMB Capital Account Business* dated 7 April 2011 (SAFE Circular), upon presenting the approval letter from MOFCOM to local SAFE branches and fulfilling relevant registration formalities, RMB capital funds could be remitted in accordance with the procedures of the current foreign investment foreign exchange system. Under an earlier *PBOC Circular to Clarify Relevant Issues in Connection with Cross-border RMB Business* dated 3 June 2011 (PBOC Circular), PBOC's permission is also necessary to open the corresponding RMB settlement account for the remitted RMB capital funds. The obligation to seek PBOC's permission lies on the account opening bank. The prevention of "hot money" inflow is one of PBOC's primary considerations when reviewing relevant applications. PBOC may refuse such account opening applications for investment in restricted industries and key industries under China's macroeconomic policy. Where the onshore entity is a financial institution, the regulatory regime is less clear, but at a minimum, the approval from the competent regulator must be obtained.

On 27 July 2011, SAFE issued the *Circular on Issues Concerning the Ratification of the 2011 Quota for Foreign Security Provided by Onshore Banks for Financing Purpose* (SAFE Foreign Security Circular). Apart from moderately reducing the total scale of the quota for financing foreign security provided by banks in China in 2011, it further clarifies that funds secured by onshore entities may not be remitted back to China by way of equity, debt, or any other form as may be determined by SAFE. This has the effect of restricting the use of the capital injection channel under discussion.

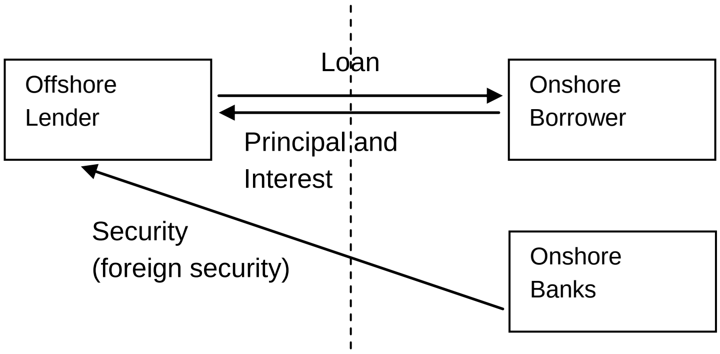
Latest Development Which Formalises the Remittance of RMB Onshore under Capital Injection

On 12 October 2011, MOFCOM published the *Circular on Relevant Issues on Cross-border RMB Direct Investment* (MOFCOM RMB FDI Circular) based on a consultation draft circulated on 22 August 2011(MOFCOM Consultation Draft). The MOFCOM RMB FDI Circular now officially formalises the channel of foreign direct investment denominated in RMB (RMB FDI) and related procedures. According to the MOFCOM RMB FDI Circular, investable RMB broadly includes RMB funds sourced from (i) RMB cross-border settlement, (ii) divestment of onshore investment; and (iii) offshore lawfully (including via issuance of RMB bonds and RMB stocks). With respect to the scope of investment, the MOFCOM RMB FDI Circular prohibits investment of RMB funds (that are remitted onshore under the head of RMB FDI) in securities and financial derivatives unless the investor is an approved strategic investor of a listed company, or otherwise be used to extend an entrustment loan. While all application for RMB FDI previously required central MOFCOM approval on a case-by-case basis, the local branches of MOFCOM are now able to approve certain applications in accordance with currently applicable regulations under the MOFCOM RMB FDI Circular. Yet, applications for investment involving special industries (e.g. financing security or financing leasing, etc.) or which exceed a specified amount (i.e. RMB300 million) must still be approved by MOFCOM at the central level. Compared to the MOFCOM Consultation Draft, the MOFCOM RMB FDI Circular is substantially similar except that it has, in accordance with market opinion, removed the proposed prohibition on repayment of domestic and cross-border loans using funds under RMB FDI. Recommendations made by market players and professional firms during the consultation period relating to the scope of legitimate channels for RMB, the permissible use of funds, the approval threshold and application procedures have apparently not been accepted as they do not appear in the MOFCOM RMB FDI Circular.

A day later on 13 October 2011, PBOC issued the *Administrative Measures on RMB Settlement for Foreign Direct Investment* (PBOC Measures). The PBOC Measures confirm that a foreign investor must open special RMB non-cash accounts with a bank before it may remit the up-front fees and capital contribution made via RMB FDI. Moreover, an FIE with RMB FDI is only required to register with the local branch of PBOC within 10 working days after the receipt of its business licence. The foreign investor will no longer be required to obtain PBOC approval to open an account with the bank. As a result, PBOC is only involved in the initial registration as well as on-going regulation and monitoring of the relevant RMB accounts.

In respect of the registration, PBOC requires the foreign investor to submit a copy of the MOFCOM approval certificate, business licence and the institutional code certificate, which in all provide the basic information of the proposed FIE with RMB FDI, including its institutional form, name, capital contribution amount, etc.

Cross-border Loan



If the onshore entity is a FIE (but not a Chinese-funded enterprise or financial institution, which is separately subject to the discussion below), it could borrow RMB loans from offshore lenders within the difference between its approved total investment amount and registered capital. In a typical case, the offshore shareholder of the FIE would act as the lender. In other cases, the offshore lender can also be a commercial bank or other institutions (e.g. the foreign affiliates of the FIE).

In accordance with the SAFE Circular, in principle, foreign debt denominated in RMB (which previously only included indebtedness denominated in a foreign currency incurred by a domestic entity and owed to a non-resident) will also be regulated under the current foreign debt regime (under which no MOFCOM approval or permission is required for SAFE to process the remittance of funds). However, under the MOFCOM Circular referred to on page 2, cross-border shareholder's RMB loan constitutes foreign direct investment that is subject to the approval procedures discussed in the section on "Capital Injection" above. An uncertainty therefore arises as to whether, in reality, MOFCOM approval would be a prerequisite for SAFE to attend to the formalities for processing cross-border RMB loan.

There are also uncertainties in the application of the law on shareholder's loan and loans extended by other lenders. The SAFE Circular does not specifically distinguish between these two kinds of loans. Rather, it only stipulates rules that generally apply to RMB-denominated foreign debt. As for the PBOC Circular referred to on page 2, while it expressly applies to shareholder's loans, it is unclear whether it also applies to cross-border loans extended by other lenders. As a result, whether the taking out of cross-border RMB loans made by non-shareholder foreign institutions is permitted still remains unclear.

If the onshore entity is not a FIE, under the current foreign debt regime, it may obtain a short-term (less than 1 year) foreign debt quota from SAFE or seek approval from the National Development and Reform Commission to incur mid-term and long-term foreign debt in order to borrow loans from offshore lenders.

In accordance with the SAFE Circular, cross-border RMB loans must be registered with SAFE under the current foreign debt registration scheme in the same way as foreign debts denominated in foreign currencies do. However, there is no need to open a special foreign currency account for RMB-denominated foreign debt. An RMB account opened for cross-border loan granted to a non-financial institution FIE will require the same PBOC permission discussed above.

The SAFE Foreign Security Circular may also affect cross-border loan. According to the SAFE Foreign Security Circular, both SAFE and the PRC bank that provides foreign security must closely examine how the offshore borrower uses the loan proceeds that is supported by the security for financing purposes. As discussed above, the use of loan proceeds supported by foreign security in refinancing existing debt or the direct or indirect acquisition of shares of an offshore company with major assets in China is prohibited.

Latest Development on RMB Cross-border Loan

With the promulgation of the MOFCOM RMB FDI Circular and the PBOC Measures, it is now clear that foreign debt denominated in RMB incurred by an FIE will likewise be counted within its foreign debt quota. However, the opening of the RMB account for foreign debt denominated in RMB and the corresponding repayment may now be processed by the bank directly. That said, as discussed in the section on "Capital Injection" on page 2 above, an RMB account for RMB cross-border loan may now be opened on the basis of the relevant loan agreement alone without the need for other government approvals, while the relevant PRC bank is only obliged to supervise the use of such RMB fund. Since the MOFCOM Circular is silent on the relationship between RMB cross-border loan and foreign direct investment, it is not clear whether the MOFCOM approval it requires refers to the typical MOFCOM approval for the establishment of a FIE or a specific MOFCOM approval on the borrowing of the RMB shareholder loan. If before an FIE is established, the shareholders intend to provide both capital injection in RMB and RMB shareholder loan, it is our understanding that the approval granted by MOFCOM or its competent local branch on the establishment will also satisfy the regulatory requirements on the RMB shareholder loan and that no additional approval is required. This should be the same as the case where a shareholder of an existing FIE intends to increase its capital contribution in RMB as well as provide RMB shareholder loan to the FIE. However, where separate approvals are required and what procedures apply are not so clear if an existing FIE merely intends to borrow RMB loan from its shareholder. It is expected that MOFCOM will clarify these practical issues soon.

Offshore Financing Sources

Lower financing cost is often one of the primary commercial considerations driving cross-border RMB financing. For example, the 10-year treasury bills issued by the PRC Ministry of Finance in Hong Kong on 30 November 2010 bear an annual interest rate of 2.48%, while those issued in Mainland China on 16 December 2010 bear an interest rate as high as 3.77%. The appreciation of RMB must also be considered in the calculation of the actual financing cost. The borrowers are expected to repay the investors "appreciated" RMB upon maturity.

Although only PRC commercial and policy banks may obtain cross-border financing by issuing bonds, RMB bonds issued in Hong Kong (also known as "dim sum" bonds) have, as a result of active participation of offshore issuers, grown to become extremely popular since last year. According to the Hong Kong government, as at the end of August 2011, a total of 68 RMB bonds were issued with an issuance size of about RMB139.2 billion (approximately US$21.8 billion). The range of issuers has expanded from PRC banks to multinational non-financial institutions.

According to the speeches delivered by the Vice Premier, Li Keqiang and the President of PBOC, Zhou Xiaochuan in Hong Kong in August, the Chinese government has decided to allow mainland institutions (including non-financial institutions) to issue RMB bonds in Hong Kong up to RMB50 billion (approximately US$7.8 billion) in 2011, of which the permissible amount for non-financial institution is RMB25 billion (approximately US$3.9 billion). In the mean time, the Hong Kong government is committed to further encourage overseas enterprises to issue RMB bonds in Hong Kong and expand channels for enterprises to invest the RMB capital raised in Hong Kong back in Mainland China.

As of July 2011, the RMB deposit in Hong Kong has accumulated to RMB572.2 billion (approximately US$89.5 billion). The RMB liquidity of Hong Kong participating banks has also increased correspondingly. In addition, Hong Kong is improving its regulatory system to facilitate the conduct of RMB banking business. For example, the Hong Kong Monetary Authority issued a circular on 9 May 2011 to clarify the RMB fiduciary cash account arrangements. This circular enables participating banks to convert the counterparty risk of Bank of China (Hong Kong) Co., Ltd. (i.e. the RMB clearing bank in Hong Kong) into credit risk of the PBOC using the fiduciary cash account arrangements, and therefore provides participating banks more flexibility in conducting RMB business. Hong Kong participating banks with RMB liquidity and shareholders obtaining RMB from such banks could be another important source of cross-border RMB financing.

As RMB IPOs take off in Hong Kong, offshore RMB financing sources are likely to increase in the near future.

Prospects

The PRC government has committed to combat inflation and control the continued rise of the domestic price level. It is envisaged that PRC regulators would maintain a prudent view over capital inflow, whether in RMB or foreign exchange. In any case, practical opportunities exist under the PRC regulatory regime to effect RMB cross-border financings for onshore projects that makes investment in the encouraged industries and foreign investors are advised to make full use of them in the interim. It is expected that more avenues would ensue as Hong Kong further elevates into an offshore RMB centre.