

Offshore bond issuance eased: SAFE issued rules to facilitate cross-border lending by PRC companies and further consults on relaxing cross-border security regulations

The Chinese government has long been attempting to loosen control on foreign exchange capital account items in order to facilitate cross-border funds flow. In its continuing efforts to speed up the process of capital account liberalisation, the State Administration of Foreign Exchange (SAFE) has issued the *Circular on Further Improving and Adjusting the Foreign Exchange Policies on Capital Account Items* (SAFE Circular), which became effective on 10 February 2014. Recently SAFE further initiated a public consultation on the removal of approval and quota requirements for provision of cross-border security and guarantees, which if implemented, may significantly alter the way offshore bond issuances are to be structured.

Key issues

The SAFE Circular effective on 10 February 2014 expands the scope of offshore borrowers and removes the time limit on validity of lending quotas of Chinese Companies. The requirement to obtain prior approval from SAFE for overseas lending is also removed if the aggregate lending amount of the Chinese Company remains under 30% of its "owners' equity". While these measures facilitate Chinese Companies to fund their overseas entities, more relaxations are awaited following the recent release of the SAFE Consultation which if implemented, would further enable Chinese Companies to provide direct guarantees or security for its offshore debts and those of its entities.

Relaxation on cross-border lending by Chinese Companies to overseas subsidiaries and affiliates

Under current SAFE rules, a Chinese non-financial enterprise (**Chinese Company**) must have obtained a lending quota approved by SAFE in order to extend shareholder's loans in foreign currencies to an overseas company in which it has an equity interest (**Offshore Borrowers**). The source of funds may come from the Chinese Company's proprietary foreign currencies, capital conversion from RMB, foreign exchange fund pools or domestic foreign exchange loan. The lending quota is valid for two years as from the date the approval was issued by SAFE, and is renewable within one month before expiration.

The SAFE Circular facilitates cross-border lending by:

- (i) expanding the scope of an Offshore Borrower to include those overseas companies that are affiliated with, but not directly owned by the Chinese Company; and
- (ii) removing the two-year limit for the validity of the lending quota, and allowing the Chinese Company to apply for a longer term of validity that satisfies its actual needs.

According to the SAFE Circular, a Chinese Company does not have to obtain prior approval from SAFE if the total lending amount which it has extended does not exceed 30% of its "owners' equity". The Chinese Company is only required to register the overseas lending agreement and the audited financial statement of the last accounting period with the local SAFE branch. However, once its total lending amount exceeds 30% of its "owners' equity", the Chinese Company is required to obtain SAFE approval on a case-by-case basis.

The SAFE Circular is consistent with the recent regulatory trend to further relax cross-border lending by Chinese Companies to overseas subsidiaries and affiliates. Back in July 2013, the People's Banks of China (**PBOC**) first relaxed the regulation on the RMB cross-border lending business of Chinese non-financial enterprises by issuing the *Notice on Simplifying the Process of Cross-border RMB Business and Improving the Relevant Policies* (**PBOC Notice**). Under the PBOC Notice, Chinese Companies may apply for the settlement of overseas RMB lending via commercial banks in China. A Chinese Company that (i) has a shareholding relationship or is ultimately controlled by the same parent company as the Offshore Borrower, and (ii) shares the same regional headquarters or the same investment manager with the Offshore Borrower, may apply to extend cross-border RMB loans by way of RMB cash pooling. These measures obviously made it more convenient for multinational companies to extend cross-border RMB loans.

In the past year, many Chinese Companies have used their offshore subsidiaries as a platform to issue bonds in the international capital markets. As it has not been easy for Chinese Companies to obtain requisite approvals from SAFE and the National Development and Reform Commission in order to act as guarantors for bond issuance by their offshore subsidiaries, they have offered them alternative forms of credit support. These include keepwell deeds, equity interest purchase undertakings and third party bank standby letters of credit. In light of the relaxations of the PBOC Notice and the recent SAFE Circular, Chinese Companies should find it easier to build liquidity support (in the form of a loan) into the bond issuance structure as another form of credit support for their offshore subsidiary.

Further liberalisation on the provision of security and guarantees for debts of offshore entities envisaged

On 13 February 2014, SAFE published a draft of the *Provisions for Foreign Exchange Control over Cross-border Security* for public consultation (SAFE Consultation), which proposes to lower the applicable threshold of certain cross-border security and to streamline the administrative procedures by removing the need to obtain prior SAFE approval. The rules under the SAFE Consultation no longer require Chinese Companies (i.e. non-financial institutions) to seek prior approval or quota from SAFE before they may provide security for the debts of their overseas entities, whether in the form of a guarantee, mortgage, pledge or other forms. If the security or guarantee is enforced, local banks are also permitted to handle transfer of funds directly to the offshore creditor.

If the rules under the SAFE Consultation are finalised and implemented, Chinese Companies will be able to structure their offshore bond issues more freely by providing direct credit support such as guarantees and security to offshore bondholders. This will be seen as a positive development by investors who, in most cases, have so far been able only to obtain alternative credit support falling short of a direct guarantee.

Other key changes introduced by the SAFE Circular

The SAFE Circular has also introduced the following key changes to the foreign exchange capital account administration regime:

- *Simplification of the documentation required for profit repatriation.* The SAFE Circular simplifies the list of documents and supporting materials required for remitting profits of domestic entities out of China. It also lifts the restriction on the amount of profits of the current financial year that may be repatriated. Previously this was set at an amount being no more than the sum of "dividends payable" and "undistributed profits" attributed to foreign shareholders in the latest audited financial statements.
- *Overseas financing offered by finance leasing companies.* The SAFE Circular requires that finance leasing companies (whether regulated by the China Banking Regulatory Commission or the Ministry of Commerce) are required to register cross-border financing which they have extended to foreign entities that are not subject to their lending quota with the relevant local branch of SAFE within fifteen business days.
- *Transfer of distressed assets to foreign investors.* The SAFE Circular removes certain pre-approval requirements during the process of transferring distressed assets from domestic entities to foreign investors and streamlines the registration procedures.
- *Preliminary expense registration of overseas direct investment by domestic entities.* The SAFE Circular now only requires documents to be submitted for preliminary expense registration of overseas direct investment by domestic entities if such expense amounts to USD3 million or 15% of the investment amount of the Chinese party (previously an expense of USD100,000 would already trigger such a requirement). A domestic entity which seeks to repatriate a lower amount of preliminary expense of overseas direct investments is only required to register at the relevant local branch of SAFE by providing its business license and organization code certificate.
- *Cross-border transfer of individual assets and foreign exchange business license of securities companies.* The SAFE Circular simplifies the procedures of and administration on transferring an individual's assets out of China, and removes the requirement for securities companies to renew their Securities Business Foreign Exchange Operation Certificates every three years.

Conclusion

With further de-regulation on foreign exchange capital account items, it is now much simpler for domestic companies in China to fund their overseas subsidiaries and affiliates through cross-border lending in foreign currencies or RMB. It also allows Chinese Companies to build in liquidity support in the form of a shareholders'

loan to support bond issuance by their offshore subsidiaries. It remains to be seen how much weight investors and credit rating agencies would assign to this alternative form of credit support.

Looking forward, if the rules proposed in the SAFE Consultation are also adopted and implemented, Chinese Companies will be allowed to give direct guarantees or security for its offshore debts and those of its subsidiaries. When that time comes, even current alternative forms of credit support now commonly used, such as keepwell deeds, equity purchase undertakings and liquidity support, might become less significant.

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