

China relaxes controls on cross-border security: implications for structuring cross-border asset finance transactions

On 12 May 2014, the State Administration of Foreign Exchange ("**SAFE**") of the People's Republic of China ("**PRC**") issued the Provisions for Foreign Exchange Control over Cross-border Security and a set of corresponding operation guidelines (collectively, the "**Provisions**") which reform the PRC's regulatory regime for cross-border security ("**Cross-border Security**", previously referred to as "**foreign security**"). The Provisions will become effective as of 1 June 2014¹.

The Provisions make significant changes to the legal regime governing Cross-border Security and signal the PRC's significant step forward in deregulating capital account transactions². This briefing focuses on the potential impact of the Provisions on structuring cross-border asset finance transactions involving PRC entities or assets.

Overview

Cross-border Security is defined in the Provisions as any security granted by the relevant security provider to the relevant creditor which (i) is in writing and binding, (ii) contains an undertaking to perform payment

¹ Although it is clear that the new regime under the Provisions will apply to Cross-border Security created after 1 June 2014, the Provisions are not particularly clear as to whether the Provisions will apply to the enforcement of Cross-border Security which is created before 1 June 2014 but may be enforced after such date.

² "capital account" transactions, as defined under the relevant PRC regulations, refer to transactions that result in any change in external assets and liabilities in international receipts and payments, such as direct investments, loans, finance leases, derivatives transactions and cross-border security interests.

obligations³ based on the relevant security contract and (iii) may lead to cross-border cash flow, title transfer or other types of transactions affecting PRC's balance of payments internationally. We consider that the term "security" under the Provisions should be interpreted to include both proprietary security interests (i.e. rights *in rem*) and contractual guarantees.

Cross-border Security is essentially classified in the Provisions as (i) onshore security for offshore credit (*Nei Bao Wai Dai*), (ii) offshore security for onshore credit (*Wai Bao Nei Dai*), and (iii) Cross-border Security in other forms. Examples of these three types are discussed below.

Nei Bao Wai Dai: *Nei Bao Wai Dai* refers to Cross-border Security provided by a PRC party (i.e. a PRC security provider) in favour of a non-PRC party (i.e. a foreign creditor) for the debts owed by another non-PRC party (i.e. a foreign debtor) (see diagram 1 below).

An example in a cross-border asset finance transaction context would be a PRC parent of a lessor/borrower established in another jurisdiction, such as Ireland or Hong Kong, giving security for the debts owed by such foreign lessor/borrower to a foreign bank or investor. The security could be a mortgage over an asset owned by the PRC parent or a guarantee from the PRC parent of the payment obligations of the lessor/borrower.

Wai Bao Nei Dai: *Wai Bao Nei Dai* by its definition refers to Cross-border Security provided by a non-PRC party (i.e. a foreign security provider) in favour of a PRC party (i.e. a PRC creditor) to secure the debts owed by a PRC party (i.e. a PRC debtor) (see diagram 2 below).

An example in an asset finance context would be where a PRC bank has provided a loan to a PRC borrower, such as a ship owner, and receives the benefit of a guarantee from an offshore shareholder of such ship owner, as part of the security package in relation to the loan.

Interestingly, in the chapter on *Wai Bao Nei Dai*, the Provisions only provide for a scenario where the onshore facility is borrowed by a PRC non-financial institution from a PRC financial institution. As such, the implications of having (i) a PRC financial institution being the borrower and/or having a PRC non-financial institution as the lender⁴ and/or (ii) other debts (such as obligations to perform operating leases) rather than a loan being the underlying "debt" remain unclear under the Provisions. In such case, it is possible (but not particularly clear under the Provisions) that the relevant security would fall under the third category of Cross-border Security in other forms.

Diagrams:

³ This is the literal translation of the relevant provision; it appears (although not particularly clear under the Provisions) that such undertaking may also be one to perform non-payment obligations in the context of a proprietary security interest.

⁴ Please note that direct inter-company loans between companies (which are not financial institutions) are not permitted in the PRC. An entrustment loan would allow a bank in the PRC to act as an agent/trustee in a loan and is normally used for inter-company lending in the PRC.

Diagram 1 (*Nei Bao Wai Dai*)

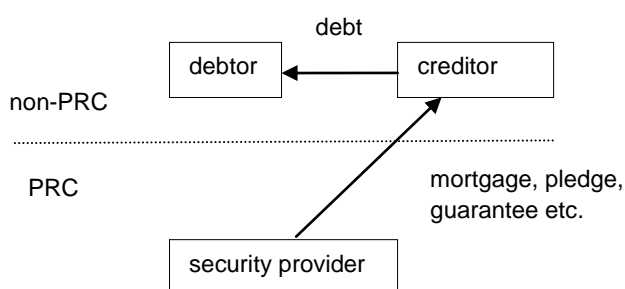
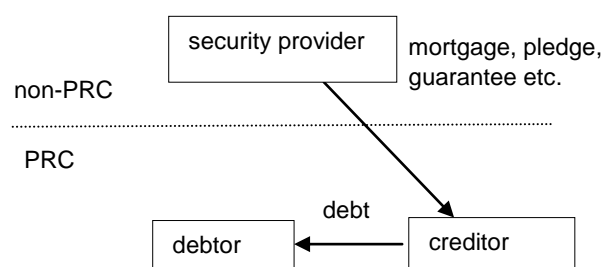


Diagram 2 (*Wai Bao Nei Dai*)



In term of the underlying "debt" in the above diagrams, it is worth noting that:

- in respect of the *Nei Bao Wai Dai* structure, the Provisions are not specific as regards the types of the debt and presumably the debt can be a loan or a lease or other indebtedness; and
- in respect of the *Wai Bao Nei Dai* structure, the Provisions expressly provide that it is a loan facility granted by a PRC financial institution to a PRC non-financial institution⁵.

Cross-border Security in other forms: Cross-border Security in other forms refers to all other types of Cross-border Security that do not fall into either the *Nei Bao Wai Dai* or the *Wai Bao Nei Dai* category. The Provisions have provided some examples (but not an exhaustive list) of such other forms:

- the security provider is located in the PRC, and the debtor and the creditor are separately located either in the PRC or a foreign jurisdiction respectively⁶;
- the security provider is located outside the PRC, and the debtor and the creditor are separately located either in the PRC or a foreign jurisdiction respectively;
- all the relevant parties are in the PRC and the underlying secured property is registered in a foreign jurisdiction; and
- all the relevant parties are in foreign jurisdiction(s) and the underlying secured property is registered in the PRC.

⁵ As mentioned above, the implications of having (i) a PRC financial institution being the borrower or other debtor and/or having a non-financial institution as the lender or other creditor and/or (ii) other debts (such as obligations to perform obligations under operating leases) rather than a loan being the underlying "debt" remain unclear under the Provisions.

⁶ This means either (i) the debtor is in the PRC and the creditor is outside the PRC or (ii) the debtor is outside the PRC and the creditor is in the PRC.

No quota or prior SAFE approval required for providing Cross-border Security: One of the most significant changes the Provisions make to the previous regulatory regime on foreign security is that the SAFE approval or quota requirements have been removed for purposes of providing any Cross-border Security.

In addition, the enforcement of Cross-border Security under the *Nei Bao Wai Dai* structure or the *Wai Bao Nei Dai* structure no longer requires any SAFE verification.

The Provisions have retained certain registration requirements which are summarised in the chart below:

	Post-signing registration required?	Procedures with SAFE after enforcement?
<i>Nei Bao Wai Dai</i>	<p>Yes.</p> <p>(1) if the Cross-border Security provider is a PRC bank, it shall report through an online system connected to SAFE or by other means to SAFE (time limit on reporting not specified under the Provisions); and</p> <p>(2) if the Cross-border Security provider is a PRC non-bank financial institution or a company, it shall register with SAFE within fifteen (15) working days after the execution of the relevant security document/guarantee⁷.</p>	<p>SAFE verification is <u>not</u> required.</p> <p>But the security/guarantee provider shall complete relevant reporting/registration with respect to "credits against non-PRC entities"⁸:</p> <p>(1) if the Cross-border Security provider is a PRC bank, it shall report through an online system connected to SAFE (time limit not specified under the Provisions); and</p> <p>(2) if the Cross-border Security provider is a PRC non-bank financial institution or a company, it shall register with SAFE within fifteen (15) working days after the enforcement of the Cross-border Security.</p>
<i>Wai Bao Nei Dai</i>	The PRC lender shall report <i>Wai Bao Nei Dai</i> information to SAFE through an online	PRC debtor shall register with SAFE with respect to short-term foreign debt within fifteen (15) working days ⁹ after the Cross-border Security is enforced.

⁷ No registration with SAFE is required if the security is provided to secure the PRC security provider's own indebtedness.

⁸ The rationale of "credits against non-PRC entities" is that, upon the performance of the security/guarantee, the PRC Cross-border Security provider would be presumably subrogated to the non-PRC creditor's claims against the non-PRC debtor (whether the subrogation can be contracted out and recognised by SAFE is unclear under the Provisions) and such "credits against non-PRC entities" are intended to be monitored by SAFE.

⁹ Foreign debt is an important concept under the PRC foreign exchange control regime, and essentially refers to a debt owed by a PRC

	system connected to SAFE or other means (time limit on reporting not specified under the Provisions).	
Cross-border Security in other forms	Not required.	In general not required, but: (1) where the Cross-border Security provider is in the PRC and the debtor is outside the PRC, upon enforcement of the Cross-border Security, the PRC Cross-border Security provider shall complete registration with respect to "credits against non-PRC entities" ¹⁰ ; and (2) where the Cross-border Security provider is outside the PRC and the debtor is in the PRC, if the enforcement of the Cross-border Security results in the change of the non-PRC creditor, the PRC debtor shall complete registration with respect to the change of the creditor with respect to the underlying debt owed by the PRC debtor to the non-PRC creditor.

Registration not required for perfection of security: SAFE also clarified in the Provisions that the registration requirements under the Provisions are not required for perfection of the Cross-border Security. In other words, failure of or delay in completing the SAFE registration *per se* will not render the relevant Cross-border Security invalid or unenforceable.

However, in the case of Cross-border Security under the *Nei Bao Wai Dai* structure provided by a PRC non-bank entity (for example, a PRC leasing company), SAFE registration evidence needs to be presented if and when the security against that PRC non-bank Cross-border Security provider is enforced and such security provider is required to remit money out of the PRC, such as guaranteed amounts or sale proceeds relating to a secured asset. The Cross-border Security provider may also be subject to SAFE's administrative penalties for such non-compliance in respect of the registration requirement. Therefore, from a creditor's perspective, the SAFE registration, if applicable, should be completed as soon as possible following closing of a transaction and the granting of such Cross-border Security, to ensure enforcement of its collateral is not restricted or subject to delay in the future.

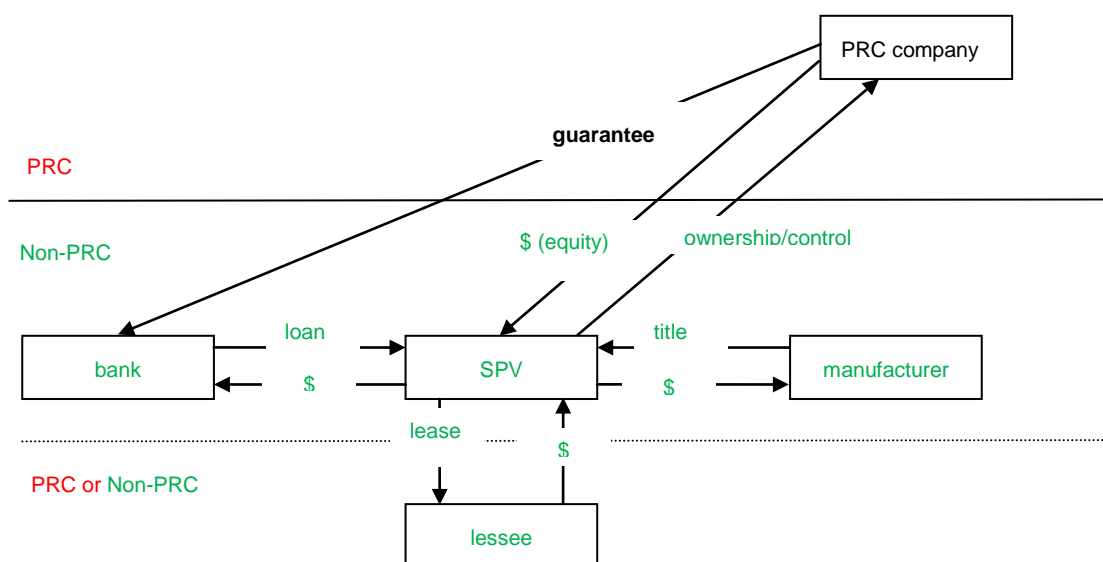
entity to a non-PRC party under capital account transactions.

¹⁰ See footnote 8 above.

Implications on structuring asset finance deals with PRC borrowers, guarantors or other obligors

Structure 1

The diagram below shows a typical structure of a cross-border asset financing to an offshore special purpose vehicle (SPV) directly or indirectly owned or controlled by a PRC company:



Once the Provisions become effective, it should be easier for the PRC company to give a guarantee in favour of the offshore bank or other financier which would be classified as *Nei Bao Wai Dai*. As discussed above, the guarantee will not be subject to any prior SAFE approval or quota requirement but should be registered with SAFE post-signing of the guarantee. SAFE will conduct a "procedural" check¹¹ only when the PRC company applies for such registration. In other words, the Provisions have cleared the previous SAFE regulatory hurdle for such PRC companies wishing to provide guarantees to secure an offshore SPVs' obligations.

There are two particular issues to note in respect of such *Nei Bao Wai Dai* structures.

Qualification to conduct "security providing business"

¹¹ Notably, "procedural" is added in the final version of the Provisions and not in the previous consultation draft issued by SAFE. According to the Provisions, SAFE may check whether the transaction is real, commercially reasonable and legal/in compliance with other regulations. When in doubt, SAFE may require written explanations from the security provider. SAFE can refuse to register if they find the explanations not sensible based on "reasonable commercial practice" and relevant regulations. How SAFE would carry out such checks is unclear under the Provisions.

The Provisions require regulated PRC banks or non-bank financial institutions (which would include, for example, PRC leasing companies subject to the regulation of China Banking Regulatory Commission ("**CBRC**"), i.e. CBRC Leasing Companies) to obtain the relevant qualification for conducting a "security providing business", if such banks or non-bank financial institutions intend to provide Cross-border Security under the *Nei Bao Wai Dai* structure.

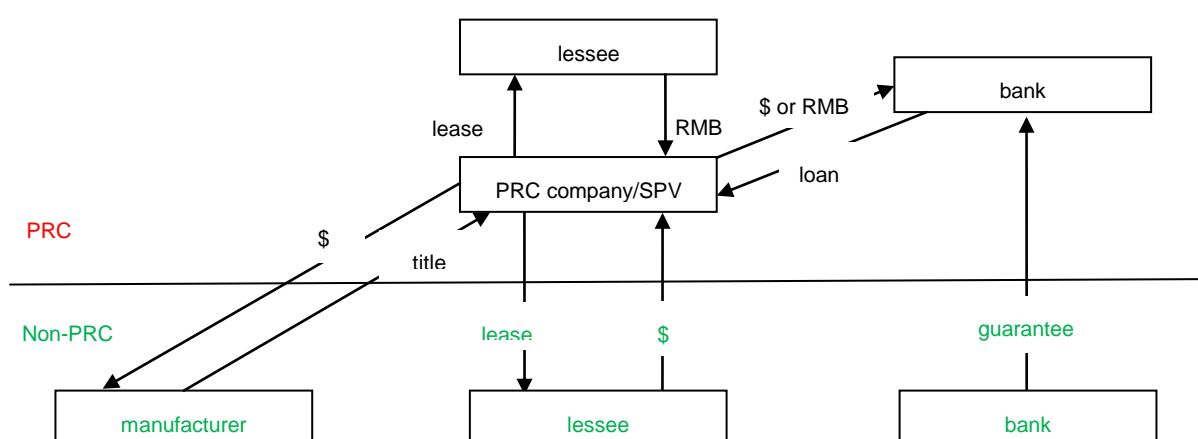
Based on the *Administrative Measures on Financial Leasing Companies* promulgated by CBRC on 13 March 2014 (CBRC Measures), CBRC Leasing Companies which "operate well and meet the conditions" can provide security for their subsidiaries' or SPVs' financings, subject to the approval of CBRC. Since such CBRC Measures have only recently been promulgated and the implementation rules are yet to be published¹², the exact conditions or application procedures required for the approval of CBRC are still unclear.

Restriction on signing new *Nei Bao Wai Dai* contracts

Where the SPV borrower or other foreign debtor, as the case may be, defaults under the loan agreement or other contract and the PRC security provider performs its obligations under any Cross-border Security (for example, a guarantee to the non-PRC financiers) in favour of the foreign secured creditor, before the PRC security provider is fully repaid by the SPV or relevant debtor¹³, the PRC security provider is restricted from signing any new *Nei Bao Wai Dai* contracts unless otherwise approved by SAFE¹⁴.

Structure 2

The diagram below shows another possible transaction structure using the *Wai Bao Nei Dai* structure:



Under this structure, the offshore bank (the foreign security-provider) provides a guarantee in favour of the PRC

¹²Please see our client briefing "*Latest CBRC rules encourage development of financial leasing companies*" at http://www.cliffordchance.com/briefings/2014/04/latest_cbrc_rulesencouragedevelopmento.html

¹³ Non-repayment due to the debtor's bankruptcy is carved out; however, how that translates into the SAFE's review remains unclear.

¹⁴ This restriction applies to any new *Nei Bao Wai Dai* contracts no matter whether it is with the same debtor/creditor or a third party.

bank (the PRC creditor) which provides a loan to a PRC company or SPV (the PRC debtor). Such a guarantee would be classified as Cross-border Security under the *Wai Bao Nei Dai* structure. The relevant PRC bank must report such *Wai Bao Nei Dai* to SAFE. Prior SAFE approval or quota requirements are not applicable. If the guarantee is enforced, the relevant PRC bank may receive and settle the funds from the offshore guarantor directly.

Registration requirement upon enforcement

Upon enforcement of the guarantee by the offshore guarantor, a debt owed by the PRC debtor company to the offshore guarantor will be viewed as "foreign debt"¹⁵ under PRC law and such foreign debt must be registered with SAFE within fifteen (15) days after the performance of the guarantee.

Restriction on signing new Wai Bao Nei Dai contracts

Before the PRC debtor company or SPV fully repays the offshore guarantor, (i) such PRC debtor company or SPV cannot enter into any new *Wai Bao Nei Dai* transactions (unless otherwise approved by SAFE) and (ii) no further drawdown is permitted with respect to a loan which has been signed but not yet utilised (or fully utilised).

The impact of the restrictions after enforcement of security under either the *Nei Bao Wai Dai* structure or the *Wai Bao Nei Dai* structure on third party creditors of the PRC debtor or of the PRC security provider will need to be analysed on a case-by-case basis as parties grapple with the new regime¹⁶. Enforcement and cross-default provisions, as well as representations and covenants relating to security, will need to be reviewed.

Conclusion

The Provisions are likely to bring significant changes to asset finance deals involving a PRC obligor or a PRC security-provider, despite the fact that, as the Provisions have only recently been promulgated, certain issues remain to be clarified, such as those identified in this briefing. By removing the approval requirement on providing Cross-border Security, the Provisions are likely to reduce transaction time and associated costs where a PRC obligor or PRC security-provider is involved. In addition, offshore financiers and PRC parties alike may benefit from the increased flexibility and certainty in receiving and enforcing security provided out of the PRC.

¹⁵ See footnote 9 above.

¹⁶ The concern may be more relevant when substantive (rather than SPV) PRC debtors or security providers are involved.

Contacts



Paul Greenwell
Hong Kong
T: +852 2825 8857
E: paul.greenwell@cliffordchance.com



Yang Tiecheng
Beijing
T: +86 106535 2265
E: tiecheng.yang@cliffordchance.com



Katherine Ke
Shanghai
T: +86 212320 7248
E: katherine.ke@cliffordchance.com



Christie Fang
Hong Kong
T: +852 2826 3454
E: christie.fang@cliffordchance.com

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Clifford Chance, 40th Floor, Bund Centre, 222 Yan An East Road, Shanghai 200002, People's Republic of China
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