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Offshore financing in Shanghai Free Trade Zone liberalized

In order to liberalise control over capital account transactions and implement further financial deregulation in the Shanghai (China) Pilot Free Trade Zone (Shanghai FTZ), the Shanghai Head Office of the People's Bank of China (Shanghai PBoC), on 12 February 2015, issued the Trial Implementation Rules on the Macroscopic Prudent Management of Account-Based Settlement Business for Offshore Financing and Cross-Border Capital Flow in the China (Shanghai) Pilot Free Trade Zone. These measures became effective on the same day, and have laid the foundation for a new legal regime (New Regime) that greatly facilitates the conduct of offshore financing activities.

This briefing looks at the regulation of the New Regime from various aspects including participants, quota, procedures, commercial terms and account administration which together offer greater flexibility for the conduct of offshore financing. It marks an important phase of financial industry reform whereby entities have increasing freedom in determining the volume and structure of the financing, against a more streamlined administrative process. The expansion of the lending quota and the clarification of the account-based settlement system under the New Regime will also facilitate the convertibility of capital account items and enhance the development of financing activities in the Shanghai FTZ.

Key features of the New Regime

Q: Who can participate in the New Regime?

The New Regime applies to offshore financing activities conducted through the FTAs or the FTUs (referred to as **Account-based Offshore Financing**), where the borrower is located within the Shanghai FTZ including the subsequently extended area of Luijiazui financial district, Jinqiao and Zhangjiang districts. Specifically, three types of entities are eligible to participate in the New Regime (**Eligible Entities**). The Eligible Entities may initiate the seeking of financing from overseas without the need for prior approval from relevant authorities.

Eligible Entities	Operational Remarks
Corporates in the Shanghai FTZ	Offshore financing activities will be conducted through the FTAs. Entities may elect to follow either the existing foreign debt and offshore financing management model or the New Regime. However, the decision will be considered final in principle, and the Eligible Entities may only change their minds once by applying to the Shanghai PBoC with legitimate reasons. Any foreign debt or offshore financing balance will be transferred to the selected management model.
Non-bank financial institutions in the Shanghai FTZ	
Financial institutions in Shanghai	Offshore financing activities will be conducted through FTUs. Eligible financial institutions should have already participated in the account-based settlement regime and established the FTUs.

Q: What are the management rules for Account-based Offshore Financing activities?

The New Regime sets out the methods to calculate the quota (Q) of Account-based Offshore Financing and the volume (V) that an Eligible Entity has utilised. The volume must not exceed the quota in any event.

Quota for Account-based Offshore Financing - the quota (Q) is determined by the capital of the entity (C), comprising paid-in capital and capital reserve, an offshore financing leverage ratio (L), and the macro prudence adjustment factor (F), which stands at 1 initially. Specifically, Q is calculated as follows:

- $Q=C\times L\times F$

L is determined according to the type of the entity. Noticeably, L has been raised from 1 to 2 for eligible corporates. With respect to non-bank financial institutions in the Shanghai FTZ, L is set at 2 or 3, depending on whether the entity opens a FTA account in another financial institution or sets up a FTU regime itself.

The New Regime further sets the FTU of the Shanghai subsidiary of a non-bank financial institution at 8% of its legal person's capital. For a branch in the Shanghai FTZ of a non-bank financial institution, the FTU is set at 5% of the domestic legal person's first-class capital.

Finally, L stands at 5 for newly-established banks with FTUs in the Shanghai FTZ, and C specifically refers to the first-class capital in this scenario. The New Regime will expand the currently limited financing channels for financial institutions.

Calculation of the volume of Account-based Offshore Financing - The volume of offshore financing (V) is calculated by multiplying the sum of the outstanding balances (B) of each loan, as adjusted by different risk factors relating to the repayment period of the loan (Pr), the currency (Cr) and the type of the loan (Tr). V is calculated as follows:

- $V=\Sigma B \times Pr \times Cr \times Tr$

The specific figure of each risk factor is assigned according to the nature of the loan, as shown in the following table.

Figure	Pr	Cr	Tr
1.5	Short term financing with repayment period of or less than 1 year The remaining financing or new financing, where more than three prepayments have been made to a medium to long term financing within a year	Foreign currency-denominated financing	—
1	Medium to long term financing with repayment period of over 1 year	RMB- denominated financing	On-balance sheet financing
0.5 or 0.2	—	—	Off-balance sheet financing (contingent liability)

The New Regime allows Eligible Entities to decide freely on the terms and conditions of an offshore financing. The financing may be denominated in either RMB or foreign currency, and the interest rates may be determined by the parties at arm's length. Nonetheless, considering the risk factors that apply, the Shanghai PBoC clearly encourages the use of RMB-denominated medium to long term financing in support of the real economy.

In calculating the volume of Account-based Offshore Financing, one must also be aware of the types of the business concerned:

Types of business that are not included for Account-based Offshore Financing - consistent with the existing PBoC and Shanghai FTZ regulations, certain offshore financing activities will not be included for the purpose of calculating the volume of Account-based Offshore Financing. These activities include (1) offshore deposits; (2) trade credit, non-financing guarantees and RMB trade financing; (3) self-use Panda bonds; (4) intra-group funds transfer within a group and (5) the amount of offshore financing that have been transferred into equity or granted with debt relief.

Types of business that are included for Account-based Offshore Financing - in order for a business to be included for Account-based Offshore Financing, adjustments are made to the volume and the risk factors according to their business nature. For example, in light of its close relationship with international trade, only 20% of the actual volume of foreign currency trade financing will be included in the calculation, and the risk factor Pr will stand at 1. Meanwhile, 20% of the contingent liability of a financial institution arising from hedging the risks associated with its clients' genuine cross-border transactions will be recorded, while 50% of the same would have to be recorded when hedging its own currency and tenor associated risks. Other businesses will be recorded according to the real transaction volume.

Utilisation of the borrowed funds - corporates and non-bank financial institutions may utilise the borrowed funds in their own production and operational activities as well as project construction within the Shanghai FTZ and outside China. Banks may utilise the funds within the Shanghai FTZ and outside China through their own operational activities that relate to account-based settlement businesses. Moreover, while under previous pilot schemes, the borrowed offshore RMB funds may only be utilised within the Shanghai FTZ or outside China, the New Regime now allows such funds to be used in China proper outside the Shanghai FTZ under the principle of limited penetration.

Issues to be clarified - the New Regime appears to cover all possible means of offshore financing, ranging from borrowing, issuing foreign currency-denominated bonds to providing foreign security (which constitutes contingent liability). However, how the New Regime applies to offshore financing other than borrowing will be subject to actual practice and further interpretation by the Shanghai PBoC. Similarly, how funds may be utilised in China proper outside the Shanghai FTZ under the principle of limited penetration awaits further guidance in practice.

Q: How will the Shanghai PBoC supervise Account-based Offshore Financing?

The Shanghai PBOC supervises Account-based Offshore Financing through the following means:

Early risk warning indicators - Shanghai PBoC will collect statistics and supervise the Account-based Offshore Financing activities by using a series of early risk warning indicators. These indicators will monitor the volume and structure of the offshore financing activities, cross-border/FTZ cash flow and credit supply demand within the Shanghai FTZ. Based on these risk indicators, the Shanghai PBoC may at times alter the risk factors, leverage ratio and macro prudence adjustment factor to control risks. Where necessary, the Shanghai PBoC may also adopt emergency measures such as regulating the total volume of offshore financing.

Information filing, onsite and offsite inspection - Eligible Entities are required to file information relating to offshore financing transactions to the Shanghai PBoC for the record. The New Regime also imposes annual information disclosure requirements. The Shanghai PBoC will conduct periodical and *ad hoc* onsite and offsite inspections and penalise behaviour of false or delayed information filing. For borrowing that exceeds the offshore financing quota or use of funds beyond the permissible scope, the borrower will be required to return the funds or be subject to fines. In extreme cases, the Shanghai PBoC may temporarily suspend the financial intuitions from conducting account-based settlement businesses and Eligible Entities from conducting Asset-based Offshore Financing business.

A comparison in summary

Since the establishment of the Shanghai FTZ in 2013, a series of pilot schemes on financial deregulation have been introduced, with greatest liberalisation having been attained in the field of offshore financing. The table below compares the requirements for offshore financing under different legal regimes applicable to borrowers at different times in different locations in China.

Key Aspects	Shanghai FTZ under the New Regime as from 12 February 2015	Shanghai FTZ before 12 February 2015	China proper
Participants	Non-bank financial institutions and corporates in the Shanghai FTZ and certain banks in Shanghai are allowed to obtain offshore financing under the New Regime.	Non-bank financial institutions and corporates in the Shanghai FTZ may borrow RMB from overseas.	Foreign-invested enterprises (**FIE**s) and qualified domestic institutions may borrow funds from overseas.
Quota	The quota of offshore financing for non-bank financial institutions and corporates in the Shanghai FTZ has been expanded. See analysis below.	The quota for offshore RMB financing is calculated by multiplying paid-in capital by a leverage ratio and a macro prudential factor. The leverage ratio for determining the quota is 1.5 and 1 for non-bank financial institutions and corporates respectively.	The offshore borrowing quota of an FIE is the difference between its approved total investment amount and its registered capital (the **Difference**). If the loans exceed the Difference, the FIE may only apply to increase the total investment amount. The offshore financing activities of a domestic entity are subject to quota control. The applicable quota is determined by the State Administration of Foreign Exchange (**SAFE**) or as approved by the State Council, depending

			on the terms of the loans.
Approval/ filling Procedure	The prior approval requirement for offshore financing is replaced by information filing system.	Prior approval requirements for offshore financing apply.	An FIE may seek offshore financing within the Difference at its own will. Offshore financing activities by domestic institutions are generally subject to the approval of the relevant authorities (e.g., SAFE and the National Development and Reform Commission) on a case-by-case basis.
Commercial terms of the loans	Offshore financing could be denominated either in RMB or foreign currency. Financing with a tenor of one year or less is allowed. The parties are free to determine the applicable interest rates.	Non-bank financial institutions and corporates in the Shanghai FTZ are allowed to borrow foreign debt denominated in RMB with a tenor of over one year.	Both offshore RMB and foreign currency denominated debts are considered foreign debt and subject to the foreign debt administration regime. The commercial terms of the loans must be submitted to SAFE for approval.

Account administration	With an account-based settlement system established in the Shanghai FTZ, funds financed from overseas are managed in the Free Trade Accounts (**FTA**s) and the Free Trade Accounting Unit (**FTU**s), subject to the same management rules regardless of their RMB or foreign currency denomination.	Foreign currency and RMB funds are managed in separate accounts. RMB funds borrowed overseas will be kept in the FTAs.	Foreign currency and RMB funds are managed in separate accounts.

Impact of the New Regime

The New Regime marks an important new phase of financial industry reform in the Shanghai FTZ. To date, several offshore borrowing transactions have already been conducted under the New Regime which offers a more relaxed environment for offshore financing. The New Regime respects and provides freedom for corporates and financial intuitions to conduct offshore financing activities and determine the volume and structure of the financing. The removal of the administration approval requirements, together with considerable expansion of the quota and possible financing channels are likely to expedite the development of financing activities in the Shanghai FTZ. The reduced cost of offshore financing should also facilitate interest rate liberalisation in China.

Likewise, the New Regime is a valuable and meaningful attempt to reform and innovate the micro-prudential control approach. Although the Shanghai PBOC will no longer examine every financing transaction, it would still be able to guide the structure of offshore financing activities efficiently through the use of risk factors. The information filing requirements, inspections and emergency measures also establishes the role of the Shanghai PBoC as the market safeguard.

Finally, the New Regime breaks up from the traditional foreign exchange control system and introduces the concept of managing RMB and foreign currency-denominated financing under one integrated legal framework. The functions and operations of the account-based settlement system are now further clarified and developed. In effect, the Shanghai FTZ takes the lead in establishing a management model for achieving convertibility of capital account items in China. These rules help to bridge the onshore and offshore financial markets and add impetus to the construction of the

Shanghai International Financial Centre. The success of this New Regime will also contribute to the development of the foreign exchange control system in China.

Conclusion

The Shanghai PBoC has expressed its ambition to introduce further reforms in the coming six months to realize financial deregulation in the Shanghai FTZ. We will monitor the developments closely and prepare follow-up briefings to capture new business opportunities and changes that might have a significant impact on your business.

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