PBoC Implements Nationwide Macro-prudential Management on Cross-border Financing

In early 2016, the People's Bank of China (PBoC) introduced a pilot macro-prudential management system for cross-border financing (MP Financing Management System) which specifically applied to 27 designated banks and non-financial enterprises registered in four free trade zones in Shanghai, Tianjin, Guangzhou and Fujian (FTZ). On 3 May 2016, the PBoC issued the *Circular on Implementing Overall Macro-prudential Management System for Nationwide Cross-border Financing* (New Circular) to extend the MP Financing Management System nationwide, which as this briefing highlights, significantly, impacts on the conduct of cross-border financing activities in a number of ways.

More eligible participants

One of the most note-worthy developments is that the MP Financing Management System would now apply to all non-financial enterprises and financial institutions incorporated in China (including both domestic enterprises and foreign-invested enterprises (FIEs)), except for real estate enterprises and government financing platforms (collectively, PRC Enterprises).

Financing limit and balance

The MP Financing Management System adopts a risk-weighted approach and involves two important concepts:

(i) risk-weighted cross-border financing limit (Cap); and

(ii) risk-weighted cross-border financing balance (Balance).

PRC Enterprises must ensure that the Balance does not exceed the Cap as calculated by the formulas below:

Cap = Capital/Net Assets * Leverage Ratio * MP Adjustment Parameter.

Capital/Net Assets equals:

(i) the net assets (for non-financial enterprises);

(ii) Tier 1 capital (for banks); and

(iii) paid-in capital plus capital reserves (for non-banking financial institutions).

Balance = Σ RMB/ Foreign-currency Cross-border Financing Amount *Risk Factor (Term) * Risk Factor (Financing Type) + Σ Foreign-currency Cross-border Financing Amount * Risk Factor (Foreign Currency).

Passive indebtedness (*e.g.* investment by offshore institutions in debt instruments issued by a Chinese issuer in China, and offshore clients' RMB deposits held with Chinese banks), RMB trade financing, indebtedness incurred under cash-pooling arrangements, and Panda bond proceeds used for onshore subsidiaries, etc. are not required to be taken into account when calculating the Balance. The New Circular requires financial institutions to use the market fair value of their specific types of off-balance sheet financings for the purpose of calculating the Balance.

The New Circular sets the following initial values:-

- Leverage Ratio: 1 (for non-financial enterprises and non-banking financial institutions), and 0.8 (for banks);
- MP Adjustment Parameter: 1;

- Risk Factor (Term): 1 (for more than 1 year (exclusive)), and 1.5 (for one year or less);
- Risk Factor (Financing Type): 1 for all kinds of financings and contingent debts;
- Risk Factor (Foreign Currency): 0.5.

These values could be reset or adjusted by PBoC (for single, multiple or all entities) based on the macro-prudential assessment or macro-control needs so as to achieve counter-cyclical adjustment and to minimize systematic risk with more flexibility.

Reporting obligations

PRC Enterprises now have the discretion to implement RMB or foreign currency cross-border financings within the Cap, and are no longer subject to the prior approval-based foreign debt system, whether determined by way of quota or on a case-by-case approval basis.

The MP Financing Management System imposes post-signing filing and reporting obligations on PRC Enterprise. For example, corporate entities are required to file with SAFE their cross-border financing contracts after execution and at least three working days before drawdown, while financial institutions are required to file with PBoC or SAFE their cross-border financing contracts after execution and before the performance of the contracts. PRC Enterprises are required to report payments and receipts under filed cross-border financings, and regularly update the relevant information that may affect the calculation of the Cap and the Balance (*e.g.* net assets /capital and changes to existing financings).

Parties to cross-border loans, debt instruments and other financing transactions must be aware of these new requirements. The same requirements apply to changes in existing foreign debt obligations and cross-border guarantees.

While PRC Enterprises are now enjoying greater freedom in executing cross-border financing transactions, they are likewise subject to more compliance requirements. In particular, a PRC Enterprise needs to monitor and ensure that its Balance is within its Cap and report and update the required information in a timely manner. It seems that banks are also required to monitor their clients' Cap.

Grace period and transitional arrangements

While the MP Financing Management System now applies to all outstanding cross-border financing transactions, the New Circular allows a one-year grace period before such requirement extends to regional pilot programmes for cross-border financings (*e.g.* in FTZs).

In addition, FIEs and foreign-invested financial institutions may choose to adopt the existing financing model (*i.e.* borrowing gap model for foreign-invested enterprises and quota/approval model for foreign-invested financial institutions), or alternatively the new model under the New Circular that triggers a filing with PBoC/SAFE. However, PBoC does not appear to have designated a transitional period for FIEs and foreign-invested financial institutions, so it is not entirely clear whether the ability of those entities to choose between the existing model and the model under the New Circular only applies during the transitional period. It is expected that PBoC/SAFE would announce the transitional arrangements in due course.

Uncertainties

While the MP Financing Management System is supposed to liberalise the foreign debt regime for PRC Enterprises, it has raised a number of questions that remain unanswered in the absence of further detailed implementation rules.

- *Interaction with NDRC Circular 2044*

  The National Development and Reform Commission (NDRC) issued a circular in September 2015 (NDRC Circular 2044) which, among other things, removed the approval requirement for PRC enterprises to borrow foreign debt with a term exceeding one year, including offshore bonds and international commercial loans. The NDRC Circular 2044 also imposed a national registration system (applicable to entities incorporated in the PRC as well as their offshore subsidiaries) which gave NDRC control over the overall foreign debt size on a country wide basis. The New Circular does not clarify how its provisions interact with the NDRC Circular 2044. Before PBoC, SAFE and/or NDRC explains further, it would be prudent for enterprises and banks to comply with both set of rules.

- *Consequences of non-compliance:*

  The New Circular provides that where a PRC Enterprise's Cap is breached due to PBoC's adjustment of the values of the relevant ratio, parameter or factor, the existing financings would not be affected but no new cross-border financing would be allowed. However, where the

Cap is breached due to reasons attributable to the relevant PRC Enterprise (*e.g.* decrease in its net assets or capital), the impact on its existing financing arrangements is not entirely clear. Although the New Circular does not specify that a subsequent breach of the Cap after the incurrence of the relevant debt obligation (due to the PRC Enterprise's own reasons) would affect the validity or enforceability of such debt obligation, there may be practical concerns regarding remittance of payments in relation to such debt obligation pending further clarification from the regulators. It would also appear that the fact that a filing has been made in respect of a particular debt obligation may not necessarily constitute conclusive evidence that the Cap has been complied with (*e.g.* where the information provided by the relevant PRC Enterprise in the calculation of the Balance/Cap is not entirely accurate).

In addition, PBoC/SAFE no long issues any formal documentation in relation to the filing of the relevant debt (*e.g.* foreign debt registration certificate under the old regime), and tends to monitor from "behind the scenes". Therefore, lenders and creditors (including bond holders) would need to consider appropriate mechanisms (including conditions precedent, representations and ongoing undertakings) to ensure that the relevant filings and reports are done when required and to monitor ongoing compliance with the Cap.

Looking forward

The New Circular shows collaboration between PBoC and SAFE through clear allocation of duties and information sharing mechanism, which is a big step ahead from the previously fragmented regulatory systems. The wider application scope of the MP Financing Management System also shows China's determination to facilitate cross-border financings and better control systematic financial risks associated with cross-border cashflow. This is a very timely development in light of the increasing number of cross-border financing activities, as China liberates its controls over capital account items and the internationalisation of Renminbi continues.

The New Circular states that SAFE would issue detailed rules separately to regulate the activities of corporate entities, and it remains to be seen how the MP Financing Management System would practically be implemented nationwide.

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