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New changes in PRC cross-border financing rules.

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On 29 April 2016, the People's Bank of China ("**PBOC**") published the "Notice on Nationwide Implementation of the Macro-prudential Management Policy of Overall Cross-border Financing" (the "Notice") (中国人民银行关于在全国范围内实施全口径跨境融资宏观审慎管理的通知), which applies to cross-border financing activities by companies (excluding government financing vehicles and real estate enterprises) and financial institutions incorporated in the PRC. The Notice came into effect on 3 May 2016.

Background

Before the issue of the Notice, foreign debt control mainly falls within the remit of the National Development and Reform Commission ("**NDRC**") and the State Administration of Foreign Exchange ("**SAFE**"). NDRC is in charge of quota control through filings made in respect of foreign debt by domestic entities and their offshore subsidiaries (by contrast, the Notice only applies to onshore entities, which do not include offshore subsidiaries of domestic entities). SAFE is responsible for monitoring and supervising the borrowing of foreign debt through registration of foreign debt agreements by both domestic entities which have obtained quota from NDRC and foreign invested entities ("**FIEs**") which have a statutory foreign debt quota equal to the difference between the total investment limit and the registered capital.

The Notice effectively extends nationwide the application of a pilot scheme initiated by PBOC in the Shanghai Free Trade Zone in early 2015. The pilot scheme introduces a new foreign debt quota system for both domestic entities and FIEs and expedites the filing procedure for domestic entities. It is viewed as a liberalising move, to encourage cross-border financing activities within the Shanghai Free Trade Zone and has since then been rolled out in the other free trade zones (Tianjin, Guangzhou and Fujian). Before the Notice was introduced, this pilot regime was running in parallel with the national regime regulated by NDRC and SAFE.

Unfortunately, in the absence of detailed implementation rules and guidance from NDRC, there remain some uncertainties about whether the two regimes co-exist or whether one prevails over the other, as discussed in more detail below.

Changes introduced by the Notice

> **New foreign debt limit:** Under the Notice, at any given time, PRC companies and financial institutions may borrow an aggregate amount of foreign debt of up to the product of (i) the borrower's net assets (for non-financial entities) or capital (for financial entities), (ii) a leverage ratio (currently set at 1 for non-financial entities and 0.8 for financial entities), and (iii) a macro-prudential parameter (currently set at 1). It is unclear, however, for non-financial entities whether net assets are calculated on a consolidated or unconsolidated basis. For banks, Tier 1 capital will be used for this calculation, while for non-banking financial institutions capital (paid-up capital plus capital reserve) will be used with reference to the latest audited financial reports.

> **Limit on outstanding debt only:** The foreign debt limitation clearly applies to the total outstanding amount of foreign debt, adjusted by risk weighting, rather than the total borrowings ever incurred (whether still outstanding or not) (which concept applies to borrowings with a tenor of one year or longer under the NDRC regime).

> **Risk Weighting**: The following factors will be taken into consideration:

- loans with a term of under one year have higher weighting than longer term loans;
- foreign currency loans have higher weighting than RMB loans;
- an 80% discount will be applied to the outstanding amount of foreign currency trade finance; and
- for the time being, off-balance sheet financings in the form of contingent liabilities have the same weighting as on-balance sheet financings, but this may change with the latter being deems more risky.

> **Exemptions and discounts**: When calculating the amount of outstanding foreign debt, certain cross-border financings are exempted, including:

- RMB denominated liabilities owed to offshore entities pursuant to their investment in the PRC bond market or deposits made by such offshore entities with PRC financial institutions;
- trade credit and RMB denominated trade finance;
- intra-group capital flows, including the re-investment of panda bonds proceeds to the issuer's onshore subsidiaries; and
- any amount of cross-border financing converted into equity or debt relief.

> **New filing procedure**: Company borrowers are required to file with SAFE after the financing agreement is signed and no later than three working days before drawdown/issue. Financial institution borrowers are required to file the details of the calculation of their outstanding

foreign debt and foreign debt limit with PBOC and SAFE before making their first cross-border financing transaction and thereafter to report to PBOC and SAFE when a financing agreement is signed and before the drawdown of the loan or issue of the bonds.

> **Choice between the two regimes**: FIEs and foreign financial institutions incorporated in the PRC (but not domestic entities) may opt into the new regime introduced by the Notice or remain under the previous regime during a transitional period. This choice is intended to be definitive in principle, meaning that once the choice is made it will be extremely difficult to revert during the transitional period (the Notice anticipates a future regulation to specify the length of the transitional period and how the two regimes will be unified after the expiry of that period). We would expect many FIEs to prefer the new PBOC regime, given that it allows the foreign debt quota to evolve after repayment of previous debt and the aggregate amount of foreign debt to adjust over time with net assets / capital. However, which regime is more favourable will depend on individual circumstances as, for example, for a FIE with substantial investment (exceeding US$ 3 million) in China, it may prefer the previous regime whereby the statutory quota (up to twice its registered capital) may allow it to borrow more than the new PBOC regime does.

Unfinished business

The Notice took effect on 3 May. However, there are some important questions left unanswered:

> is filing with NDRC still required for domestic entities which wish to opt into the new regime? Under the NDRC regime, they are required to use quota by filing a notice of foreign debt with NDRC. The Notice, however, is silent as to whether, under the new regime, a domestic entity is still required to submit its NDRC filing documents to SAFE when obtaining SAFE registration. In our view, it would be prudent for domestic entities to comply with the filing requirement unless and until NDRC abolishes such requirement.

> in addition, is it still possible for NDRC to grant a foreign debt quota greater than the new foreign debt limit introduced under the Notice? From a purely formal legal point of view, despite the issuance of the Notice, NDRC still has delegated authority from the State Council to oversee foreign debt control.

As a result, we will need to watch closely for the reaction of NDRC to the Notice (currently we expect NDRC is likely to insist on the filing requirement).

Generally, FIEs should not be concerned with the ambiguity mentioned above. Although not explicitly excluded from the NDRC rules, in practice as long as an FIE is not ultimately controlled by a PRC entity or PRC national, it does not need to make filings with NDRC. With the introduction of the new regime, in principle FIEs can either opt to use the new foreign debt limit or remain with their original foreign debt quota, equal to the difference between total investment limit and registered capital.

For government financing vehicles and real estate enterprises, which are excluded from the application scope of the Notice, the existing NDRC rules will apply and such entities should make foreign debt filings with NDRC as before (for completeness, SAFE prohibits foreign-funded real estate enterprises incorporated after 1 June, 2007 from borrowing any foreign debt).

According to the Notice, detailed implementation rules in relation to cross-border financing by non-financial institutions will be issued by SAFE separately. Hopefully, those rules will be able to clarify the uncertainties highlighted above. Before the implementation rules are introduced, in practice we would expect SAFE may still follow the previous practice whereby domestic entities still need to comply with applicable NDRC quotas and make filings with NDRC and foreign invested entities are subject to the existing statutory quota.

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