GARRIGUES
Commentary

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PBOC promulgates new cross border financing rule in China's four free trade zone

On January 22, 2016, the People's Bank of China ("PBOC") issued the Notice Regarding *the Expansion of the Pilot Scheme for Macro Prudential Management of Cross Border Financing* ("PBOC Notice") (《中国人民银行关于扩大口径跨境融资宏观审慎管理试点的通知》) which was implemented on 25 January 2016.

PBOC defines the Cross Border Financing as the capital in RMB or foreign currency financed by non-resident enterprises or individuals to domestic institutions. After a certain period running of the macro prudential management regime of cross border financing in Shanghai Free Trade Zone, this year, PBOC decides to expend the new cross border financing management regime to four free trade zones, i.e. Shanghai, Guangdong, Tianjin and Fujian.

The new management regime is very different from the current foreign debt quota regime in China. The key features of this new regime are introduced as follows:

1. Macro Prudential Management Policies

Subject to cross border financing restrictions based on borrowing enterprises' capital or net assets, which are established in line with the new macro prudential policies, pilot enterprises (exclusive the financial institutions other than the selected banks, governmental financing platforms and real estate enterprises) and 27 selected pilot banks can raise fund in RMB or foreign currency from overseas at their own discretion.

"**Cross Border Financing Risk Weighted Outstanding**" and "**Upper Limit of Cross Border Financing Risk Weighted Outstanding**" constitute two main features of the new cross border financing policies. Cross Border Financing Risk Weighted Outstanding refers to the aggregate amount of the outstanding debts in RMB and foreign currency after multiplying the risk weight. Upper Limit of Cross Border Financing Risk Weighted Outstanding is the product of net assets (or the capital), cross border financing leverage ratio and the macro prudent adjustment parameter.

The piolet enterprises and piolet banks would be able to obtain cross border finance within Cross Border Financing Risk Weighted Outstanding, which shall not exceed the Upper Limit of Cross Border Financing Risk Weighted Outstanding.

Cross Border Financing Risk Weighted Outstanding

Cross Border Financing Risk Weighted Outstanding = Σ RMB financing balance * tenor risk ratio *category risk ratio + Σ foreign currency financing balance * exchange rate risk ratio

Tenor risk ratio is set at 1 for mid-to-long term debts (with tenor exceeding 1 year) and at 1.5 for short-term debts

Category risk ratio is set at 1 if it is an "on balance sheet" financing and at 0.2 or 0.5 if it is classified as an "off balance sheet" financing (or a contingent debt).

Exchange rate risk ratio is set at 0.5

In relation to foreign currency trade financing, 20 % of foreign currency trade financing shall be taken into account in the calculation of the Cross Border Financing Risk Weighted Outstanding, and the tenor risk ratio under this circumstance is set at 1 uniformly.

As stipulated in the PBOC Notice, in general, fund borrowed in RMB or foreign currency from non-residents entities to pilot enterprises, both the on balance sheet debts and the off balance sheet debts, must be included for the calculation of the Cross Border Financing Risk Weighted Outstanding, but some categories of debts are expressively carved out by the PBOC. Take the piolet enterprises as an example, the exclusive categories of debts are as follows:-

- **Passive RMB Debt:** passive debt in RMB result from offshore entities' investing to domestic bond market;
- **Trade Credit / RMB Trade Finance:** trade credit of pilot enterprises incurred from genuine cross-border trade and RMB trade financing obtained from offshore financial institutions;
- **In-Group Fund Transfer:** debts of pilot enterprises incurred under cross-border cash pooling arrangements (which are established for the management of cash flow of legal business operations and industrial investments) duly approved by the authorities;
- **Self-used Panda Bonds:** RMB bonds issued by the offshore parent companies to fund its onshore subsidiaries; and
- **Transfer and Exemption:** any amount of cross border debts converted to equity or is exempted.

<u>Upper Limit of Cross Border Financing Risk Weighted Outstanding</u>

Upper Limit of Cross Border Financing Risk Weighted Outstanding = Net assets * Cross border financing leverage ratio (currently 1 for pilot enterprises, subject to PBOC's adjustment from time to time) * Macro Prudent Adjustment Parameter (currently set at 1, subject to PBOC's adjustment from time to time)

2. Flexible Filing Procedure

Compare to the existing foreign debt filing procedure, i.e. applying for SAFE registration within 15 business days after the signing of the offshore loan contract, pre-record filing and registration is not required by the new cross border financing regime, pilot enterprises could make a filing with SAFE's capital information system no later than 3 business days before the drawdown, which gives more flexibility to the piolet enterprises.

3. Parallel Cross Border Financing Regimes

The Macro Prudential Management Policies does not prevent the FIEs from continuously adopting the existing foreign debt quota regime to obtain offshore financing within the difference of the total investment and the registered capital. But the FIEs could only select to adopt one regime, which means if the FIE decides to adopt the macro prudential management regime; it could not revert to the existing foreign debt quota regime unless it is approved by the in-charge authority.

4. Other issues to be further clarified by the authorities

The PBOC Notice stipulates that the fund transfer in the cross border financing can be handled under the general domestic and foreign currency account, which hints that the piolet enterprise could convert the borrowed foreign exchange at will for the current SAFE policies allow the foreign exchange under the general domestic and foreign currency account to be converted into RMB freely. However the PBOC Notice further regulates that the piolet enterprises could convert the foreign exchange funds into RMB upon its actual need for its own manufacturing and operation, which according to current practice shall provide contract, invoice or other evidence before the banks to certify the existence of actual need. The contradiction shall be further clarified by SAFE.

5. Conclusion

The promulgation of this new cross border financing rules seems showing a tendency for adopting a more loose supervision towards the in-flow of capital in China. Under this new regime, pilot enterprises are granted more autonomies with respect to raising money from cross border financing. They can choose to raise money from the domestic market or from offshore markets to decrease the financing cost.

For the FIEs, before making the final decision of choosing which regime, it is suggested to evaluate the pros and cons of two cross border financing regimes based on its financial status.

In addition, we will pay attention on the practice and the implementation measure to be promulgated by SAFE and keep you posted.

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