

China's Reform on Administration of Foreign Debts – What to Expect

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On 14 September 2015, the PRC National Development and Reform Commission ("NDRC") promulgated the Circular on Promoting Reform on the Administration of Filing and Registration of Foreign Debt Issued by Enterprises (《国家发展改革委关于推进企业发行外债备案登记制管理改革的通知》) (the "Circular"). The Circular came into effect on the date of promulgation.

Key Features

The Circular introduced significant changes to the existing regulatory framework on PRC cross-border loans and bond issuance. Highlights of the key features are as follows:

- The Circular abolished the old case-by-case approval system for incurrence of foreign debts and replaced it with a pre-issuance/incurrence registration and post-issuance/incurrence filing system. The Circular allows PRC enterprises (including foreign invested enterprises ("FIE")) meeting certain specified criteria to raise funds offshore by the issuance of bonds or loans (whether denominated in RMB or other currencies) provided that they complete the requisite filing and registration with NDRC.
- The issuer/debtor is required to apply to NDRC for registration before a foreign debt issuance/incurrence and NDRC will decide whether to accept the application within 5 working days of the application date. The documents to be submitted include an application report and an issuance/incurrence plan setting out the currency, amount, interest rate, term, use of proceeds and repayment/fund flow details. NDRC will then complete the registration by issuing a certificate of registration within 7 working days of the date of acceptance of the application provided that the overall quota is still available.
- In addition, the issuer/debtor is required to complete the relevant procedures for inflow and outflow of funds raised from the foreign debt by presenting the certificate of registration from NDRC. Presumably such relevant procedures include the foreign exchange requirements of the State Administration of Foreign Exchange ("SAFE"). A filing of the issuance/incurrence information is also required to be made with NDRC within 10 working days of the completion of each issue/incurrence.
- The total volume of "foreign debt" will be subject to an annual overall foreign debt quota set by NDRC. When the quota is used up, NDRC will make an announcement publicly and will not accept any further applications for registration.
- The Circular adopts a definition of "foreign debt" that is different from the definition of the same term under the existing SAFE regulations and practices. "Foreign debt" under the Circular includes debt instruments (including bonds and medium- and long-term international commercial loans, etc.) for a term of more than 1 year (whether denominated in RMB or other currencies) by PRC enterprises (including FIEs) as well as the offshore enterprises or branches controlled by such PRC enterprises.

- Before the issuance of the Circular, an FIE was able to borrow foreign debt within its “borrowing headroom” (i.e. the difference between its total investment and registered capital) without any overall quota limitation, and offshore enterprises or branches controlled by PRC enterprises were not regulated by NDRC or SAFE. This means, while the Circular makes it easier for PRC domestic companies to raise foreign debt, FIEs and offshore enterprises or branches controlled by PRC enterprises may now have to comply with additional requirements, such as filing and obtaining approval, and being restricted by the quota limitation.

Policy behind the Circular

One of the stated policy reasons behind the Circular is to allow PRC enterprises to benefit from the lower funding costs in the offshore debt market. The funding source of PRC domestic companies has traditionally been limited principally to either local RMB bank financing based on the PBOC benchmark interest rate or private sector borrowings. The new regime makes it possible for PRC domestic companies to tap offshore funding pools directly.

The reforms under the Circular also aim to simplify foreign debt administration, facilitate cross-border financing and enhance the growth and development of PRC enterprises.

The setting of a foreign debt quota allows NDRC to maintain control over the scale of foreign debt raised and help in diverting funds to “key industry, areas and projects” encouraged by the PRC government. Priority will be given to existing projects such as “the Belt and the Road” (一带一路).

Observations and Potential Opportunities

Subject to further clarification on the uncertainties mentioned below, the Circular presents the following potential opportunities for PRC enterprises, banks and other loan and bond market participants:

- *More level playing field for cross-border financings?* Prior to the promulgation of the Circular, offshore lenders were effectively precluded from lending directly to PRC domestic enterprises because cross-border loans to these domestic enterprises required NDRC's approval on a case-by-case basis which PRC domestic enterprises have found almost impossible to obtain. Offshore lenders could, subject to registration of the loans with SAFE, lend directly to FIEs with foreign debt quotas provided that the foreign exchange conversion and application of these loan proceeds in the PRC comply with SAFE's requirements. As a result, the pool of PRC borrowers available to offshore lenders has generally been limited to FIEs, a relatively small subset of PRC enterprises. PRC banks and other lending institutions, on the other hand, have been enjoying a regulatory advantage on lending business in relation to PRC domestic enterprises. The Circular has lowered this regulatory barrier to entry for offshore lenders seeking to expand their PRC direct lending business.
- *Allows better structuring for offshore exposure to PRC credits?* Currently, the most common route for offshore lenders and bondholders to gain exposure to PRC credits is through offshore lending or bond transactions with (a) offshore special purpose vehicles owned by PRC domestic enterprises (common for bond transactions); or (b) offshore special purpose vehicles that own indirectly PRC operating assets (for example, companies listed on the Hong Kong stock exchange). Factors such as regulatory hurdles mentioned above, ease of enforcement and intended use of proceeds have been the primary drivers behind the structuring of these offshore credit transactions. However, an inherent deficiency in such typical offshore credit structure is the lack of access to credit support (i.e. asset security or guarantees) from PRC enterprises because SAFE does not permit the proceeds of these offshore credit transactions that benefit from PRC-sourced credit support to be repatriated for use in the PRC. Such SAFE restriction on repatriation of proceeds raised in offshore lending or bond transactions, however, do not apply in direct PRC cross-border lending or bond transactions where the issuer/debtor is a PRC enterprise. As a result of the above limitation in transaction structure, offshore creditors are in effect subordinated to PRC creditors which lend directly to PRC enterprises with the benefit of such credit support. With the promulgation of the Circular, it would be interesting to see if offshore lenders and bondholders will continue to adopt the offshore special purpose vehicle credit transaction structure mentioned above.

The Uncertainties

However, there are potential challenges and uncertainties behind these opportunities.

- We should point out that repatriation of loan proceeds, currency conversion and repayment outflows are administered by SAFE (or the People's Bank of China ("PBOC"), in the case of cross-border RMB transactions), not NDRC. The Circular does not address its relationship with the requirements under the current foreign debt regime administered by SAFE and PBOC. Until SAFE and PBOC announce any changes to their current requirements or practice in order to facilitate the reform under the Circular, the uncertainties remain.
- A more significant impact is on offshore companies which are "controlled" by PRC enterprises. The Circular has no definition of "control". It would seem that "control" may not be limited to offshore subsidiaries but may extend to offshore companies over which one or more PRC enterprises exercise de facto control, through the board of directors or otherwise, even though the relevant PRC enterprise's shareholdings in such companies may be less than 50%. Before the Circular, such offshore companies were not required to obtain PRC regulatory approval before raising foreign debt. Following the Circular, it appears that parties to a bond issuance or loan transaction involving such offshore companies or branches which contemplate the remittance of funds in and out of the PRC may have to consider whether the Circular will be applicable even if the transaction is purely offshore.
- The Circular does not specify the consequences of non-compliance with the requirements under the Circular. It is expected that failure to complete the necessary NDRC registration may restrict the debtor/borrower's ability to remit the proceeds of the foreign debt into the PRC.
- NDRC has not yet published any specific annual foreign debt quota or any details on the "key industry, area and projects" which are given a priority under the Circular. It remains to be seen the extent to which PRC enterprises will be able to benefit from the reform. For instance, if the quota is very small, then the reformed registration system will not make things easier for most companies as compared to the old approval regime. In addition, if a particular industry or company is not included in the priority list, such industry or company will not benefit from the new regime at all. To the contrary, they may even need to consider whether their traditionally unregulated purely offshore issuances will be adversely affected by the new regime as discussed above.
- Under the Circular, the PRC enterprises proposing to issue foreign debt must satisfy the following basic requirements: (1) good credit record, (2) there shall be no default under their existing bonds or other debts, (3) good corporate governance and sound foreign debt risk management mechanism and (4) strong ability to repay. These criteria are general and subjective. In the absence of any objective and measurable standards/limits, the NDRC registration regime will likely to be more akin to an approval system rather than purely procedural.
- The Circular provides that NDRC will develop an online registration system as soon as possible. It is hoped that when the online registration system is put in place and operational, such system will give market participants a better idea of NDRC's requirements.

Practical Considerations

Before the above uncertainties are clarified and detailed implementation measures or infrastructures (e.g. the setting up of the online registration system mentioned in the Circular) are put in place, the parties to a transaction should:

- consider, with the assistance of appropriate legal counsel, if the Circular would be applicable and, if applicable, incorporate the requirements under the Circular into the transaction documents as conditions precedent, hard undertakings or soft further assurances, as appropriate; and

- liaise with the relevant PRC authorities on the detailed requirements and timing concerned and process the relevant registration application at an early stage in order to allow sufficient time to iron out any issues during the process. We understand that a market participant has seen a successful case of NDRC issuing a registration certificate for an offshore bond issuance by a PRC state-owned enterprise recently. This case shows that, while the online registration system is not yet operational, NDRC already has the required processes in place for the relevant registration and filing under the new regime.

Conclusion

Despite the uncertainties discussed above, the Circular represents the initiatives taken by the PRC government to reform and further liberalise the foreign debt regulatory framework. It is important for market participants (both onshore and offshore) to continue to monitor any clarification or adjustment on the implementation details.

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