New PBOC Circular potentially raises the overseas borrowing ceiling for borrowers in China: but is it a game changer?

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On 11 January 2017, the People's Bank of China ("**PBOC**"), China's central bank, issued the *People's Bank of China Circular on Matters relating to the Full Bore Macroprudential Administration of Cross-Border Financings* ("**New PBOC Circular**"). The stated aims of the New PBOC Circular are to further expand the space in which enterprises and financial institutions can engage in cross-border financing, facilitate the full deployment of overseas low-cost overseas capital, and lower 'real economy' financing costs.

Background

The so called "Full-bore Macroprudential administration of overall cross-border financing" ("**Foreign Debt Quota System**") was initially launched in the China (Shanghai) Pilot Free Trade Zone in early 2015. Before then, domestic capital companies ("**Domestic Companies**") were only permitted to incur foreign debts by borrowing overseas subject to approval by the relevant Chinese governmental authorities on a case-by-case basis[1], whilst foreign-invested enterprises ("**FIEs**") were permitted to incur foreign debt in an amount not exceeding the difference between their approved and registered total investment amount and their registered capital ("**Difference Amount**"), and were only permitted to incur foreign debt beyond the Difference Amount subject to approval by the relevant Chinese governmental authorities on a case-by-case basis. Under the new Foreign Debt Quota System, both Domestic Companies and FIEs are entitled to incur foreign debts, and are subject to the same formula when calculating the quota and balance of foreign debts. In addition, foreign debts in both RMB and foreign currencies are regulated in an integrated fashion, which simplifies regulatory oversight of this area. Looked at another way, it is a reverse leveling of the playing field: allowing Domestic Companies to have access to the same international financing channels as were historically only open to FIEs, making them better able to compete against those FIEs.

The Foreign Debt Quota System has been rolled out by PBOC in short order, against the background of the current policy position where - at the time of writing, China is strictly controlling foreign currency outflows and encouraging foreign currency inflows by means of Foreign Direct Investment in particular. Presumably the goal is to increase inflows of RMB and foreign currency by bringing more loan principal into China.

On 22 January 2016, PBOC issued the *People's Bank of China Circular on Expanding Pilot Programs for the Full-bore Macroprudential Administration of Cross-Border Financings* ("**Circular No. 18**"), which introduced the Foreign Debt Quota System to China (Guangdong) Pilot Free Trade Zone, China (Tianjin) Pilot Free Trade Zone, China (Fujian) Pilot Free Trade Zone and 27 banking-type financial institutions. Four months later, on 29 April 2016, PBOC issued the *People's Bank of China Circular on the Nationwide Implementation of the Full-bore Macroprudential Administration of Cross-Border Financings* ("**Circular No. 132**"), rolling out the Foreign Debt Quota System nationwide. The New PBOC Circular, which replaces Circular No. 18 and Circular No. 132, retains the Foreign Debt Quota System, but

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[1] Under the *National Development and Reform Commission on Promoting Enterprises Issuing Foreign Debt Record Filing System Registration System Circular* dated 14 September 2015, "foreign debt" was redefined as offshore indebtedness incurred by a company within China (境内企业), or any foreign company or branch controlled by a PRC company, where the terms of such indebtedness is of a term of 1 year or more. It abolished the previous quota system such that no prior approval was required from NDRC, however, prior registration with NDRC was required 10 days before issuing the debt. It is not clear whether this rule was intended to apply to FIEs as well as Domestic Companies.

further expands the rights of enterprises and financial institutions in China to borrow from overseas and incur foreign debts.

Foreign Debt Quota System

Under the New PBOC Circular, companies (excluding government financing platforms and real estate enterprises) ("**PRC Enterprises**") and financial institutions with legal person status incorporated in the PRC ("**PRC Financial Institutions**", collectively, "**PRC Borrowers**") are permitted to incur foreign debts, provided that the PRC Borrowers cross-border financings risk-weighted balance ("**Risk-weighted Balance**") does not exceed their individually calculated cross-border financing risk-weighted balance ceiling ("**Balance Ceiling**").

The Risk-weighted Balance equals (a) the aggregate amount of the product of (i) cross-border financings balance in RMB and/or foreign currencies ("**A**"), (ii) the term risk conversion factor ("**B**") and (iii) the categorized risk conversion factor in question ("**C**"), plus (b) the aggregate amount of the product of (i) the cross-border financing balance in foreign currencies ("**D**") and (ii) the exchange rate risk conversion factor ("**E**").

The Balance Ceiling is the product of (i) capital (for PRC Financial Institutions) or net assets (for PRC Enterprises) of the borrower ("**F**"), (ii) cross-border financing leverage ratio ("**G**") and (iii) macroprudential regulatory parameters ("**H**").

To express it in a formula:

Risk-weighted Balance ≤ Balance Ceiling

Risk-weighted Balance = A x B x C + D x E

Balance Ceiling = F x G x H

Changes Introduced by the New PBOC Circular

Compared to Circular No. 132 (Circular No. 18 was replaced by Circular No. 132), the following changes were made to the New PBOC Circular, which are mainly designed to enlarge the borrowing capacity of PRC Borrowers in terms of incurring foreign debts:

- The New PBOC Circular broadens PBOC's administrative oversight on cross-border financings to the domestic branches of foreign banks. When calculating its Balance Ceiling, the capital portion of the calculation shall include the working capital of the domestic branch of a foreign bank.
- The New PBOC Circular changes the cross-border financing leverage ratio of PRC Enterprises from 1 to 2, which significantly enlarges the Balance Ceiling within which PRC Enterprises are entitled to incur foreign debts.
- The New PBOC Circular contains additional exempt items which will be excluded when calculating the Risk-weighted Balance of PRC Borrowers. The New PBOC Circular sets forth the following six (6) categories of exemptions:

(i) Passive liabilities

Under Circular No. 132, the passive RMB liabilities incurred by PRC Borrowers through overseas institutional investments in the PRC securities market, and the RMB deposits placed by overseas entities with PRC Financial Institutions, were excluded when calculating the Risk-weighted Balance.

Under the New PBOC Circular, this category is further expanded to include (i) passive liabilities in foreign currencies incurred by PRC Borrowers through overseas institutional investments in the PRC securities market; (ii) deposits in foreign currencies placed by overseas entities with PRC Financial Institutions; (iii) funds placed by a qualified foreign

institutional investor (QFII) or an RMB qualified foreign institutional investor (RQFII) in the custody of a PRC Financial Institution; and (iv) funds raised from the issuance of RMB-denominated bonds in the PRC and deposited in escrow accounts opened with a PRC Financial Institution.

(ii) Trade credits and trade financing

Under Circular No. 132, trade credits generated by PRC Enterprises involving genuine cross-border trade (including payables and advance receivables) and RMB trade financings obtained from overseas financial institutions by PRC Enterprises, and various RMB trade financings generated through conversions in and out of RMB conducted by PRC Financial Institutions on the basis of genuine cross-border trade, will be excluded when calculating the Risk-weighted Balance.

Under the New PBOC Circular, this category is further expanded to include (i) trade financings in foreign currencies obtained from overseas financial institutions by PRC Enterprises, and (ii) various trade financings in foreign currencies generated through conversions in and out of RMB conducted by PRC Financial Institutions on the basis of genuine cross-border trade.

(iii) Intra-group capital flows

The restriction that intra-group capital flows shall be limited to cash flows generated by production and business operations, industry investment and other activities in compliance with the law was removed under the New PBOC Circular. This broadens the scope to include entrustment loans for cash pooling and financing purposes, for example.

(iv) Overseas interbank deposits, interbank lending, affiliated banks and subsidiary bank transactions

Overseas interbank lending is newly included in the New PBOC Circular as an exempt item that will be excluded when calculating the Risk-weighted Balance.

(v) Panda bonds for self-use; and

Panda bonds for self-use refer to RMB-denominated bonds issued within the PRC by the overseas parent company of a PRC Enterprise to be used as principal for loans extended to its PRC-based subsidiary. This exemption remains unchanged from under the Circular No. 132 and the New PBOC Circular.

(vi) Transfers and reliefs.

In cases where a PRC Enterprise or a PRC Financial Institution converts the proceeds of a cross-border financing into a capital increase or has obtained debt forgiveness, the corresponding amount will not be counted. This exemption remains unchanged from under Circular No. 132 and the New PBOC Circular.

- Under the New PBOC Circular, offshore loans secured by onshore security ("**Nei Bao Wai Dai**") provided by PRC Financial Institutions to clients will be included in the calculation of Risk-weighted Balance at a rate of 20%, whilst under Circular No. 132, the corresponding amount to be included was fair value. This amendment has, in essence, increased the PRC Financial Institutions' coverage quota on Nei Bao Wai Dai 5 times.

Transitional Provisions for the two regimes

The New PBOC Circular took effect on issue. However, RMB and foreign currency overseas financings and other such innovative regional cross-border financing pilot programs adopted by the PBOC and the State Administration of

Foreign Exchange ("**SAFE**") pursuant to the New PBOC Circular shall enter into force on 4 May 2017.

FIEs (excluding foreign-invested real estate enterprises)[2] and foreign financial institutions are granted a one-year transitional period from the date of issue of the New PBOC Circular, during which they may either:

- opt into the Foreign Debt Quota System under the New PBOC Circular; or
- stick to the current regime that they adopt (under the current regime, FIEs (excluding foreign-invested real estate enterprises) are entitled to freely incur foreign debts up to the amount equal to the Difference Amount).

Upon expiration of the transitional period, the New PBOC Circular shall be applied to foreign financial institutions automatically, whilst the applicable regime of cross-border financing on FIEs will be decided by the PBOC and SAFE after evaluation of the roll out of the new regime.

Conclusion – a Game Changer or Not?

Given that the New PBOC Circular has further expanded the capacity of PRC Borrowers to borrow overseas and incur foreign debts (for example by adjusting the cross-border financing leverage ratio of PRC Enterprises from 1 to 2, which is a significant relaxation), we would expect many FIEs and foreign financial institutions to opt for the Foreign Debt Quota System under the New PBOC Circular over the existing system. Overall, this is clearly an upgrade and a more sophisticated system that will allow Domestic Companies to borrow more freely overseas (Chinese governmental authorities[3] case by case approval to borrow overseas was, we understand, rarely given under the old regime). For FIEs, there will be a collective sigh of relief as China finally moves away from a system that was ill-adapted to the financing needs of a modern day company in China, onerous in terms of administration, and essentially based on debt-equity ratios that were laid down in the *State Administration of Industry and Commerce ratio between the Registered Capital and Total Investment Amount of Sino-foreign Equity Joint Venture Enterprises Tentative Provisions* (the "**FIE Debt-Equity Ratio Provisions**"), promulgated on 1 March 1987!

Clearly it makes much more sense for FIEs[4] to borrow based on risk-weighted assets rather than debt-equity ratios which were, as the (possibly apocryphal) legend goes, introduced to combat over-leveraging by FIEs, after a Hong Kong developer bought a hotel in China with 99% leverage in the 1980s, with the predictable adverse outcome.

Another interesting observation of the New PBOC Circular is that it lumps together onshore and offshore RMB debt (overseen by PBOC) and cross-border forex debt (overseen by SAFE) as far as the calculation for the risk-weighted balance is concerned, pointing to the fact that it is the total balance of debt that counts, but notably only factors in cross-border financings in calculating the Risk-weighted Balance, thus providing tacit support to those who took the view the Difference Amount under the FIE Debt Equity Ratio Provisions should not include domestically incurred RMB bank debt, only cross-border foreign debt (and now cross-border RMB debt). It remains to be seen whether PBOC and SAFE, whose relationship has not always been completely cordial and cooperative (and often competitive) since SAFE was spun out of PBOC years ago, can create a joint information platform that works so that they are both seeing both sides of the currency picture.

For bank-type financial institutions, it is a slightly odd set up, with the "Club of 27" falling to be regulated by PBOC (with only three foreign-invested banks making the cut) and the

[2] The new regime is not applicable to foreign-invested real estate enterprises.
[3] Both NDRC and SAFE approvals.
[4] Domestic Companies and financial institutions were not subject to debt-equity ratios.

rest together with companies being regulated by SAFE. This suggests that China is taking a view as to which banks merit / need direct central bank regulation in this regard, the criteria for which are not specified on the face of the New PBOC Circular. The relaxation of the controls on Nei Bao Wai Dai will no doubt be welcomed by those banks with a business in that space.

More interestingly still, the issue the New PBOC Circular raises is whether and to what extent the New PBOC Circular opens up the door to leveraged financing transactions in China, which historically have always been stymied by the maximum 3:1 debt to equity ratio under the FIE Debt-Equity Ratio Provisions at a total investment of US$30 million or higher.

We have developed a model whereby clients can provide the relevant numbers and the model will "spit out" the Risk-weighted Balance and the Balance Ceiling. On a simple side-by-side comparison (see below) where we have substituted registered capital for the net asset or capital field, there appears to be a benefit at levels with a total investment of below US$30m, but at total investment levels above that, there seems to be only marginal improvements in the borrowing capacity. This is, of course, a deliberate over-simplification and may produce a different result for MNCs with low levels of cross-border financings and high levels of net assets. Please contact any of the authors of this alert to run a simulation for your China entity.

Current Scheme

Total Investment ("TI")	**Minimum Equity (% of TI)**	**Permitted Borrowings (% of TI)**
≤ US$3 million	70%	30%
> US$3m but ≤10 million	50% or US$2.1 million (whichever is higher)	50%
> US$10m but ≤30 million	40% or US$5 million (whichever is higher)	60%
> US$30 million	33.3% or US$12 million (whichever is higher)	67.7%

Current vs New scheme

Investment / Minimum Equity	**Permitted Borrowings (under current scheme)**	**Ceiling (new scheme)**
US$3.0m / US$2.1m	US$0.9m	US$4.2m
US$10.0m / US$5.0m	US$5.0m	US$10.0m
US$30.0m / US$12.0m	US$18.0m	US$24.0m
US$40.0m / US$13.3m	US$26.7m	US$26.6m
US$50.0m / US$16.7m	US$33.3m	US$33.3m
US$100.0m / US$33.3m	US$67.7m	US$66.7m

For Domestic Companies, which until recently struggled to borrow offshore, the change is much more fundamental as compared to FIEs, and opens up a whole new front in terms of structuring both inbound and outbound transactions, for example:

- could a foreign investor now put secured debt funding into the Domestic Company in a Variable Interest Entity structure directly on a cross-border basis?
- could an offshore bank or financier lend cheaper offshore money to finance an outbound acquisition by the Domestic Company?
- could an offshore financier be issued convertible instruments by a Domestic Company that would convert into equity interests based on certain agreed triggers?

We have only just scratched the surface in terms of the new structuring options involving Domestic Companies: in that sense at least, it is a real game changer.

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