

# Client Alert.

November 2010

## New SAFE Notice Relaxes Restrictions over External Guarantees<sup>1</sup>

By Xiaohu Ma, Adam Kearney, Ray Liu and Winston Yu

In a broad overhaul of China's foreign exchange control rules on the provision of forex guarantees, the State Administration of Foreign Exchange ("**SAFE**") issued the Notice of the Issue of the Administration of External Guarantees by Domestic Institutions (国家外汇管理局关于境内机构对外担保管理问题的通知) (the "**Notice**") on July 30, 2010.

The Notice amends two existing regulations in this area that emerged during the Asian financial crisis, namely the Administrative Measures for the Provision of External Guarantees by Domestic Institutions (境内机构对外担保管理办法) and the Detailed Rules for the Implementation of the Administrative Measures for the Provision of External Guarantees by Domestic Institutions (境内机构对外担保管理办法实施细则), which took effect in October 1996 and January 1998, respectively (together, the "**Old Rules**").

In broad terms, the Notice has relaxed existing restrictions on the provision of "external" (i.e., foreign exchange denominated) guarantees by removing or watering down various requirements previously imposed upon both guarantors and debtors under the Old Rules as well as by simplifying the administrative procedures for the provision of external guarantees. These changes appear to be in line with other recent policy shifts designed to support outbound investments.

The Notice classifies guarantors as banks, non-bank financial institutions and enterprises<sup>2</sup> and amends the Old Rules in many respects. The amendments include changes to the scope of qualifying debtors for whom external guarantees can be provided, the details of requisite financial qualifications of such debtors, verification criteria for the external guarantees quotas provided by banks, the performance of external guarantees provided by banks and the quotas for guarantees provided by non-banking financial institutions and enterprises.

### BANKS AS GUARANTORS

Most of the previous restrictions in the Old Rules that applied to banks acting as guarantors have been removed or significantly weakened by the Notice which may serve as a boon for external guarantee business provided by banks. For example, when banks are providing external guarantees of a "financing nature", restrictions are no longer imposed upon the debtors' qualifications. This change should provide banks with the freedom to determine the underlying risks based solely on their own commercial judgment without reference to debtor qualification rules or any administrative restrictions other than SAFE's pre-approved quotas. Moreover, when banks are providing external guarantees of a "non-financing nature", they are no longer required to obtain a quota or prior approval from SAFE, provided that certain requirements under the Notice are satisfied. In addition, the requirement for prior approval from SAFE has been revoked in order to further expedite the process for banks when their external guarantees need to be enforced.

<sup>1</sup> For the purpose of the Notice, external guarantee should refer to the security provided by a China onshore entity (guarantor) in favor of an offshore entity (beneficiary) by means of guarantee, mortgage, pledge, etc.

<sup>2</sup> For the purpose of the Notice, enterprises shall refer to non-financial institution legal persons other than banks and non-bank financial institutions.

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## ENTERPRISES AS GUARANTORS

The Notice has also removed or watered down previous mandatory qualifications for debtors seeking guarantees from non-bank financial institutions or enterprises. For example, when enterprises are providing external guarantees, the range of eligible debtors has been enlarged to include domestic or foreign entities established by, or whose equity is held directly or indirectly by, such enterprise guarantors, in comparison to the Old Rules under which enterprises could only provide external guarantees for their direct subsidiaries.<sup>3</sup> Debtor qualifications have similarly been softened with the Notice removing the rule that an external guarantee may not be provided for debtors operating at a loss. Instead, the Notice now requires only that debtors have recorded a profit for one of the last three years with even less stringent rules for debtors who have a shorter operating history. The new provisions are more in line with commercial reality given that those offshore entities which are most in need of financing are normally at the early stage of their development in which operating losses are more the norm than the exception, making it very difficult to obtain external guarantees under the Old Rules.

In addition, the requirement that debtors must meet certain net asset ratios has been replaced with a more liberal requirement that debtors need only have a positive net asset value. From an administrative perspective, the Notice also introduces the concept of a predetermined quota to be made available not only to banks, but also to those enterprises that need to provide external guarantees frequently. In comparison to the case-by-case approval process stipulated under the Old Rules, such quota system can be expected to expedite the granting of external guarantees.

## TAKEAWAYS

Over the past couple of years, outbound investments by PRC entities have been bolstered by a series of policy moves designed by the PRC government to reduce barriers in place under the old system. However, offshore entities established in connection with outbound investments have from time to time experienced difficulty in obtaining financing abroad, due in part to the difficulty of obtaining enforceable credit support from PRC sponsors or guarantors. Therefore, removing the barriers to provision of outbound guarantees and other credit support by local PRC banks or onshore affiliates of such entities was necessary to further support outbound acquisition activity. The advent of the Notice, which removed or mitigated some of the previous limitations imposed under the Old Rules, has made it more practicable for those offshore entities to obtain domestic credit support when they are most in need of funding.

However, although banks have been granted considerable freedom in the provision of external guarantees, enterprises are still subject to many of the remaining restrictions. For example, eligible debtors are still limited to certain affiliates of the enterprise guarantors, and the percentage of enterprise guarantors' net assets must not be less than 15% of their total assets. For enterprises, amendments to the Old Rules are more in the nature of technical revisions rather than fundamental changes. These restrictions likely reflect SAFE's unwillingness to cede jurisdiction in this area perhaps due to macroeconomic concerns.

It is also interesting to note that the Notice revokes the de facto exemption previously enjoyed by wholly owned foreign enterprises ("WFOE") under the Old Rules and provides that WFOEs shall, if no quota is granted, obtain SAFE's approval on a case-by-case basis for each external guarantee provided. In reality, the new requirement does not represent a major departure from actual practice, given that the exemption set out under the Old Rules was rarely recognized in practice.

<sup>3</sup>The Notice does not provide detailed guidelines on how to determine the ownership of equity directly or indirectly; for example, whether 1% ownership is sufficient, or whether external guarantees could be provided to an offshore entity with a multiple-level corporate structure. Determinations of equity ownership will be subject to further clarification through practice.

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Given that banks are now enjoying much more relaxed SAFE administration of domestic enterprises which provide external guarantees in respect of obligations of their offshore subsidiaries, it may be advisable to use banks as intermediaries, perhaps under asset-based counter-guarantee arrangements, given their relatively loose regulatory oversight.

ASPECTS OF COMPARISON	NOTICE	OLD RULES
<b>SCOPE OF DEBTORS</b>	<ul style="list-style-type: none"> <li>• For external guarantees of a financing nature provided by a bank, the debtor shall not be subject to restrictions such as equity relationships with domestic institutions, net asset ratio, profit-making status, etc.</li> <li>• Where a bank provides external guarantees of a non-financing nature, at least one of the two parties, namely, the debtor or the beneficiary, shall be a legal person lawfully registered and established in China or an institution established overseas by (and with stakes directly or indirectly held by) a domestic institution in accordance with the relevant provisions.</li> <li>• If the guarantor is a non-banking financial institution, the debtor shall be a legal person lawfully registered and established in China or an institution established overseas by (and with stakes directly or indirectly held by) a domestic institution in accordance with the relevant provisions.</li> <li>• Where an enterprise provides external guarantees, the debtor shall be an enterprise established in China or overseas by (and with stakes directly or indirectly held by) the guarantor in accordance with the relevant provisions.</li> </ul>	<ul style="list-style-type: none"> <li>• The debtors shall be the offshore-registered wholly owned subsidiaries of domestic enterprises in China, enterprises with foreign investment and domestic institutions, and enterprises with a portion of equity interest held by a Chinese party.</li> <li>• A domestic enterprise shall only provide external guarantees for its direct subsidiaries or for the same portion of debt as the amount of investment made in an enterprise by such domestic enterprise.</li> </ul>
<b>REQUIREMENTS ON FINANCIAL INDICATOR OF DEBTORS</b>	<ul style="list-style-type: none"> <li>• Where a non-bank financial institution or enterprise is the guarantor:                             <ul style="list-style-type: none"> <li>○ The amount of net assets of the debtor shall be of a positive value;</li> <li>○ The debtor shall have made profit in at least one of the past three years (changed to at least one of the past five years for resource development and such other long-term projects); and</li> </ul> </li> </ul> <p>If the debtor has been established for less than three years (an ordinary enterprise) or five years (resource development enterprise), there shall be no compulsory requirements on profit-making.</p>	<ul style="list-style-type: none"> <li>• Where the debtor is a trading enterprise outside of China, its proportion of net assets and total assets shall be, in principle, no less than 10%; where the debtor is a non-trading enterprise outside of China, its proportion of net assets and total assets shall be, in principle, no less than 15%.</li> <li>• The debtor shall not be an enterprise operating with a loss.</li> </ul>

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ASPECTS OF COMPARISON	NOTICE	OLD RULES
<b>BASIS FOR VERIFICATION OF INDICATOR FOR QUOTA OF EXTERNAL GUARANTEES PROVIDED BY BANKS</b>	<ul style="list-style-type: none"> <li>Shall, on the basis of the consolidated paid-in capital for both domestic currency accounts and foreign currency accounts or the net foreign exchange assets, in principle, not exceed 50% of the consolidated paid-in capital or working capital for both domestic currency accounts and foreign currency accounts, or the amount of net foreign exchange assets.</li> </ul>	<ul style="list-style-type: none"> <li>Not exceeding the paid-in capital in foreign currency or consolidated working capital.</li> </ul>
<b>PERFORMANCE OF EXTERNAL GUARANTEES PROVIDED BY BANKS</b>	<ul style="list-style-type: none"> <li>Cancellation of formalities for pre-approval of performance of external guarantees provided by banks.</li> </ul>	<ul style="list-style-type: none"> <li>Performance of external guarantees provided by banks shall be pre-approved by SAFE.</li> </ul>
<b>ADMINISTRATION OF EXTERNAL GUARANTEES PROVIDED BY NON-BANKING FINANCIAL INSTITUTIONS AND ENTERPRISES</b>	<ul style="list-style-type: none"> <li>Mainly case-by-case examination and approval, supplemented by quota administration.</li> </ul>	<ul style="list-style-type: none"> <li>Case-by-case examination and approval (except for implementation of balance administration specially approved by SAFE).</li> </ul>
<b>PROPORTION OF NET ASSETS TO TOTAL ASSETS ON PROVISION OF EXTERNAL GUARANTEES BY ENTERPRISES</b>	<ul style="list-style-type: none"> <li>Not lower than 15% in principal.</li> </ul>	<ul style="list-style-type: none"> <li>For the provision of external guarantees by a domestic trading enterprise, its proportion of net assets and total assets shall be, in principal, not less than 15%.</li> <li>For the provision of external guarantees by a domestic non-trading enterprise, its proportion of net assets and total assets shall be, in principal, not less than 30%.</li> </ul>

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ASPECTS OF COMPARISON	NOTICE	OLD RULES
<b>RELATIONSHIP OF BALANCE OF EXTERNAL GUARANTEES TO SIZE OF FOREIGN EXCHANGE INCOME</b>	<ul style="list-style-type: none"> <li>• The indicator for balance of external guarantees verified for the enterprise by the foreign exchange bureau or the balance of external guarantees verified on a case-by-case basis shall not exceed 50% of the net assets of such enterprise.</li> <li>• The amount of debt under the external guarantee shall not be restricted by the size of the guarantor's foreign exchange income.</li> </ul>	<ul style="list-style-type: none"> <li>• The sum of the balance of external guarantees, domestic foreign exchange guarantees and foreign exchange debts of a financial institution shall not be more than 20 times its own foreign exchange funds.</li> <li>• The balance of external guarantees provided by a non-financial enterprise shall not be more than 50% of its net assets or its foreign exchange income in the preceding year.</li> </ul>

For further information, please contact:

**Xiaohu Ma**  
 Hong Kong  
 +852 2585 0868  
[xma@mofo.com](mailto:xma@mofo.com)

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