

Finance

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On 5 July 2013, the People's Bank of China ("PBOC") issued the "Circular on Simplifying the Cross-Border RMB Business Procedures and Improving Relevant Policies" (《关于简化跨境人民币业务流程和完善有关政策的通知》), the "Circular". The Circular simplifies the regulatory procedures and provides greater flexibility for almost all types of cross-border RMB business, including current account cross-border RMB settlement, cross-border RMB loans and the issuance of offshore RMB bonds by domestic non-financial institutions. The Circular cites: (i) increased efficiency of RMB business, and (ii) acceleration of the internationalization of RMB, as its objectives.

This note focuses on clause 5 of the Circular ("**Clause 5**"), which from its literal reading could potentially have a significant impact on the offshore PRC financing market. Clause 5 provides that "a domestic non-financial institution may grant a guarantee or security denominated in RMB in favour of a foreign entity (in this note referred to as "**Outbound RMB Security**") provided that it complies with the Property Law, the Security Law and all applicable PRC laws." It is important to note that Clause 5 does not refer to the regulations and implementation rules issued by the State Administration of Foreign Exchange ("**SAFE**") in respect of the guarantees or security provided by domestic non-financial institutions in favor of foreign entities (in this note referred to as "**Outbound Security**").

Clause 5 then goes on to provide that "upon enforcement of such Outbound RMB Security, the domestic account bank (of that Outbound RMB Security provider) may process its RMB payment (from its onshore account to the offshore beneficiary) after the bank has verified the authenticity of the transactions and the RMB payment may also be made directly by use of the offshore RMB funds held by that domestic non-financial institution." The only regulatory procedure mentioned in Clause 5 is for "the domestic account bank to log the payment information into the cross-border RMB settlement information system after the relevant payment is made as a result of any enforcement".

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This is not the first time Outbound RMB Security has been the subject of supplemental regulations:

- On 9 April 2011, SAFE issued the “*Circular regarding the Procedures for RMB Cross-border Capital Account Business*” (《关于规范跨境人民币资本项目业务操作有关问题的通知》), which provides that “RMB guarantee/security provided by domestic institutions shall in principal be regulated pursuant to the existing outbound security/guarantee regulations and rules.” This regulation essentially imposed a quota system for Outbound Security provided by financial institutions and a case-by-case approval procedure for non-financial institutions.
- On 3 June 2011, PBOC issued the “*Circular on Clarifying Issues in relation to Cross-border RMB Business*” (《关于明确跨境人民币业务相关问题的通知》), providing that “a domestic financial institution may grant Outbound RMB Security provided that it complies with the Property Law, Security Law and all applicable PRC law” and “provision of such Outbound RMB Security by such financial institutions shall not be regulated under the foreign debt regime.”

Since the June 2011 PBOC circular, anecdotally domestic banks have been issuing Outbound RMB Security on the assumption that such transactions are not subject to the quota system imposed by SAFE.

While Clause 5 appears to settle the case for Outbound RMB Security provided by non-financial PRC institutions, at this point Clause 5 must be approached with some skepticism and caution. Outbound Security has long been regarded as falling under SAFE control. In the Circular, PBOC did not expressly rule out the possibility of SAFE’s control (even though that seems to be the most logical, but not the only possible interpretation). Furthermore, the Circular provides no upfront filing or pre-clearing mechanism that can provide some certainty and comfort until actual enforcement.

Given the above, from the perspective of the creditors that may be the ultimate beneficiary of such Outbound RMB Security from a PRC company, how certain can they be that such guarantee/security is enforceable and that, upon enforcement, proceeds can be repatriated out of China without SAFE’s approval? While a definitive answer will have to wait for the first “test” case of enforcement of such guarantee/security, there are two more fundamental questions the answers to which may provide same insight:

1. Does PBOC have the authority to rule over RMB Outbound Security?

SAFE, established in 1979, is an administrative agency administered by PBOC tasked with drafting rules and regulations governing foreign exchange market activities, and managing the state foreign exchange reserves. PBOC authorized SAFE to regulate the Outbound Security under the “*Administrative Measures for Outbound Guarantee/Security by Domestic Institutions*” (《境内机构对外担保管理办法》) that PBOC issued in 1996, which set the restrictions on Outbound Security for the first time. As of today, SAFE is still a bureau under the State Council that is managed by PBOC. That is to say, PBOC is not only the authority that created the concept of Outbound Security but is also the direct supervisor of SAFE. In addition, if one carefully reads the constitutional mandate documents of these two institutions, SAFE’s coverage is limited to foreign exchange, while RMB falls under the monetary policy section which is one of the key functions of PBOC.

2. Does it make sense for PBOC to liberalize RMB Outbound Security?

The reasons PBOC set restrictions on Outbound Security in the first place was said to be an anti-avoidance clause to assure “effective contribution of registered capital”. If a foreign investor could have its PRC subsidiaries guarantee the investor’s offshore debts, then the debts of that investor would effectively become the debt of the PRC Subsidiaries. Enforcement of that debt would subvert the aims of the requirement for minimum registered capital.

The restrictions supported the fundamental policy at the time to attract and retain foreign investments. However, nowadays, even though China still tries to attract foreign investment, it maintains the biggest foreign exchange reserve in the world and is no longer the same developing country as it was in 1990s. Except for certain industries such as real estate where the authorities are desperate to cool off speculative investment, the general trend appears to be the loosening of controls, first over current accounts and now the capital accounts.¹ We would suggest that it may be time for the RMB regulations to further align with this market trend.

¹ On 28 April 2013, SAFE issued the “*Administration Measures for the Registration of Foreign Debt*” (《外债登记管理办法》). On 11 May 2013, SAFE issued the “*Administrative Measures for Foreign Direct Investments*” (《外国投资者境内直接投资外汇管理办法》). Both the measures have substantially simplified the relevant regulatory procedures.

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