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NEW REGULATION RELAXES LENDING RULES TO SPUR OUTBOUND INVESTMENT

Introduction

On 9 June 2009, the State Administration of Foreign Exchange (**SAFE**) issued the *Notice on the Administration of Domestic Enterprises Extending Loans to Overseas Subsidiaries* (**Notice**), which will come into effect as of 1 August 2009. The Notice loosens the restrictions on foreign exchange loans and formalizes Article 11 of the draft *Rules for the Administration of Foreign Exchange for Outbound Investments* (**Draft Rules**), circulated by SAFE for public opinion in May of 2009.¹

While the Draft Rules proposed a comprehensive new framework for the use of foreign exchange in outbound investment projects, the Notice pertains specifically to foreign exchange loans extended by domestic companies to their overseas subsidiaries. It replaces the rules previously in place under the *Notice on the Administration of the Internal Foreign Exchange Management of Multinational Companies* (**Notice No. 104**, issued by SAFE on 18 October 2004).

The Draft Rules and the Notice are less restrictive than Notice No. 104, indicating a desire by SAFE to facilitate access to foreign exchange and promote investments abroad by Chinese companies. The timing of the Notice indicates a sense of urgency: in revising Notice No. 104, SAFE is relaxing its rules on parent company loans ahead of the legislative process needed to enact the Draft Rules.

Background

Over the past several years, China has promoted a "going abroad" policy to encourage Chinese companies to invest overseas. However, lack of financing channels for their overseas subsidiaries together with the prevailing global financial crisis has impeded the policy's implementation.

While Notice No. 104 permitted overseas subsidiaries to receive loans from their Chinese parent companies, these loans were subject to tight restrictions. As a result, Chinese companies have been relatively reluctant to invest in projects requiring the use of such loan vehicles.

SAFE has been considering relaxing the rules on foreign exchange loans since 2007, when it established a pilot program at its Ningbo bureau. After receiving positive feedback about

¹ Please refer to our newsflash of 18 June 2009, entitled "Draft Rules Indicate Easing of Foreign Exchange Controls for Outbound Investments".

the program, SAFE decided to promulgate a formal policy nation-wide. This culminated in the issuance of the Notice, which reflects various aspects of the Ningbo program.

Key Reforms in the Notice

1. Qualifications to Extend a Loan

- Notice No. 104: Stipulated that in order to extend a foreign exchange loan to an overseas subsidiary, the Chinese parent company must have at least three overseas subsidiaries and over US\$ 5 million in overseas investments.
- The Notice: Relaxes this qualification as follows:
 - (a) Both the parent company and its subsidiary must be duly established and their registered capital must be fully paid-up.
 - (b) Both entities must keep up-to-date and accurate operating records, have a well-established financial and corporate government system, and have no record of non-compliance in their operating records or corporate governance system over the past three years.
 - (c) The parent company's previous overseas investment projects must have all been approved by the competent authorities and registered with SAFE, and must have received a minimum score (B or above) in its most recent annual outbound investment inspection carried out by SAFE and the Ministry of Commerce.
 - (d) The overseas subsidiary must not have defaulted on any previous loans.

2. Term of the Loan

- Notice No. 104: Prescribed that a parent company must extend loans to its subsidiaries within six months after such loans were approved by SAFE. All loans were required to be repaid within two years.
- The Notice: Allows parent company loans to be extended over up to two years. The parent company can also apply to renew such two-year period with SAFE at least one month before the original term expires. Unlike Notice No. 104, there is no prescribed time limit on when the loans need to be repaid.

3. Loan Source

- Notice No. 104: Stipulated that parent company loans must have been sourced from the parent company's own foreign exchange reserves.
- The Notice: Expands the sources available for such loans to include:
 - (a) the parent company's own foreign exchange reserves;

- (b) foreign currency purchased by the parent company with Renminbi; and
- (c) the parent company's foreign exchange capital pool (foreign exchange permitted to be used by a company and its subsidiaries), approved by SAFE.

4. Loan Amount

- Notice No. 104: Stated that the amount of a parent company loan could not be greater than 20% of the equity interest of the parent company.
- The Notice: Expands this amount to the lower of (a) 30% of the equity interest of the parent company and (b) the total amount of its approved overseas investments.

5. Revolving Loans

- Notice No. 104: Did not allow revolving loans. That is, once a loan amount was approved by SAFE, the parent company could not re-extend any portion of that loan, even if the subsidiary paid back part or all of the loan before its maturity date.
- The Notice: Permits additional loans to be extended in amounts equivalent to previous repayments by the subsidiary during the two-year approved term of the loan.

Analysis

The Notice and Draft Rules illustrate an attempt by SAFE to streamline the rules pertaining to outbound investments and to relax requirements for foreign exchange loans. This should encourage more Chinese companies to set up subsidiaries abroad and ease liquidity problems at existing overseas subsidiaries.

However, easier access to foreign exchange loans could promote outbound investment at the expense of other government priorities such as managing foreign exchange. Once a loan is extended to a subsidiary outside of China, the government's ability to regulate the money is significantly weakened. For instance, loans given to an overseas subsidiary could be used to fund an overseas investment (which by law needs to be approved) that avoids the regulatory purview of the government. To mitigate these risks, many restrictions still remain under the Notice. As detailed above, these restrictions include limitations on the amount and source of a loan, as well as restrictions on the qualifications of the entities engaging in these loan transactions.

The implementation of the Notice is likely to provide a good indication of the direction of future reforms. If the Notice is successful in encouraging more Chinese companies to expand overseas without any significant drawbacks, the current rules will likely either be kept or further relaxed and the Draft Rules may be implemented in their current or similar form. However, if the Notice benefits the going abroad policy while weakening the government's overall regulation over outbound investments, more restrictive rules on extending loans may be re-introduced that revoke some of the provisions in the Notice and

the to-be-enacted Draft Rules.

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