

China

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China Strengthens Supervision on Offshore Chinese Yuan (RMB) Lending

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In 2016 stabilizing the exchange rate of Chinese yuan (also known as RMB, the legal currency of China) was a critical challenge for Chinese government. Due to the recent staggering devaluation of RMB, the People's Bank of China (PBOC) promulgated a series of policies and regulations aim to tighten and scrutinize capital outflow. Among these policies and regulations is the Notice on Further Clarifying Relevant Matters Applicable to Offshore RMB Lending Business of China-based Enterprises (Notice 306), dated November 29, 2016.

In addition to our firm's [previous alert](#), which mainly provides a general background of the new policy in relation to China's recent restrictions on outbound investment by Chinese companies, this article focuses on a more specific perspective, offshore RMB lending—a common financing method of overseas entities with Chinese affiliates.

Unlike prior notices, Notice 306 was not formally published. However, based on our informal telephone consultations with China's State Administration for Foreign Exchange (known as "SAFE") and various Chinese banks, we understand that SAFE and the banks have gradually implemented the measures required by Notice 306.

Notice 306 applies when a Chinese entity lends funds to its offshore affiliate. Because the term "Chinese entity" can be broadly defined to include a Chinese subsidiary of an international company, Notice 306 can apply to an intercompany loan between the Chinese subsidiary and any of its offshore affiliates, including its offshore parent. Consequently, Chinese companies as well as multinationals operating in China could face new delays due to the tougher restrictions on movement of capital out of China. Prior to the issuance of Notice 306, offshore RMB lending was conducted in accordance with the *Notice on Streamlining Cross-Border RMB Business Processes and Fine-tuning Relevant Policies*, issued by the PBOC on May 7, 2013 (Former Notice). Because the Former Notice was enacted at a time when capital outflow was encouraged, the Former Notice imposed only a few restrictions on offshore RMB lending. Notice 306 now imposes strict requirements and mandatory regulatory approvals for this type of lending. These measures are intended to reduce capital outflow from China.

The major changes under Notice 306 are:

- A direct shareholding relationship must exist between the China-based lender and the offshore borrower. Previously, the lender and the borrower could have an indirect shareholding relationship or be under common ownership.
- The Chinese-based lender must be a non-financial company, or if it is a financial company, a financial company that exists within a corporate group (企业集团财务公司在 Chinese) that only serves its members of the corporate group.
- Registration with the local branch of SAFE is now required before the loan proceeds can be remitted. There is no time limitation as to how long the SAFE registration will take.
- The loan amount is subject to a cap that is calculated based on a complicated formula which takes into consideration, among other things, the amount of the lender's prior offshore RMB lending during the last five years.
- The source of the lender's funds must not be derived from assets of any individual or debt financing of the lender.
- The interest rate charged by the lender must be commercially reasonable, and in any event greater than zero percent (0 percent).
- The term of the loan must be for a period between six months to five years, and it can only be extended once. If the loan is not punctually repaid and the borrower does not provide reasons (or provides reasons that are not deemed to be "reasonable"), SAFE can decline any new RMB lending between the same parties.

In view of these new requirements, approvals for offshore RMB lending under Notice 306 have certainly gotten more complicated and more difficult to obtain. Further, the terms of these loans are no longer driven by commercial discussions but by government policies. While it is uncertain the extent to which these measures are to be applied, by adding more scrutiny to the approval process, the Chinese government now has the flexibility to increase or decrease capital outflow as it seems fit.

We should note that officially China has not changed its commitment toward international expansion. As a matter of fact, one day prior to the issuance of Notice 306, various Chinese authorities including the National Development and Reform Commission, the Ministry of Commerce, the PBOC and the SAFE jointly stated that China would continue to adhere to its "Going Out" policy, which is to support China-based companies and individuals to invest overseas. It has been said that the recent strengthening of the Chinese government's supervision over offshore RMB lending was meant to reduce illegal or speculative offshore RMB lending and not to prohibit business-driven capital outflow. The true effects of Notice 306 remain to be seen.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

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