The Skeleton Regime of China Administration of Foreign Debts

Description

China is still on the way to open up its capital account in terms of cross-border capital flow, in a well-calculated manner.

When looking at China's management of its foreign debts, one can easily get dizzy while navigating through tons of rules that have been issued, revised and replaced frequently over time.

This post only attempts to give you a basic idea on the skeleton of China's administration regime in regard of its foreign debts.

I. Foreign Debt

By "**foreign debt**", it means the incurrence of a debt denominated in foreign currency by a domestic entity to a non-resident. A domestic entity means a permanent institution set up in accordance with Chinese laws including government agency, companies, enterprises and other social institutions.

In essence, a foreign debt is a loan or indebtedness borrowed by a Chinese company from abroad.

A foreign debt can be of a sovereign nature or of a commercial nature. We talk about international commercial loans that are borrowed by private China entities from private lenders abroad, banks, foreign companies (including shareholders of a foreign-invested company in China.

A foreign debt can be a long term one (with a term of more than one year) or a short term one (with a term up to one year inclusive).

II. How to Borrow a Foreign Loan

China is still carefully controlling its overall foreign debts and the composition thereof (long-term versus short term) meticulously fending off global financial shock waves.

When it comes to the administration of foreign debts incurred by a China company (including foreign-invested enterprises), the rules are distinctly different to domestic companies (meaning no foreign equity/shares in them) and to foreign invested companies/enterprises.

(1) Even now, a domestic company cannot borrow foreign money without prior approval from either China National Development and Reform Commission ("NDRC") or from China State Administration of Foreign Exchange ("SAFE"). China NDRC is in charge of approving long-term foreign debts and China SAFE is charge of approving short-term foreign debt.

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(2) Foreign banks (including those locally incorporated) in China are subject to a piece of special regulation in regard of foreign debts that are incurred. In essence, quotas of such foreign debts are subject to yearly approval by NDRC in respect of long-term debts and yearly approval by SAFE in respect of short-term debts.

(3) Unlike a domestic company borrowing foreign money, a foreign invested-company in China is subject to less stringent restrictions.

Upon setting up a foreign-invested limited liability company in China, such a foreign-invested company shall decide on its total investment amount and its registered capital. There is a piece of special rules setting out the ratio between total investment amount and the amount of registered capital and the latter is always less or equal to the amount of the former. The difference is the foreign debt quota for this foreign-invested company.

Subject to this quota, a foreign invested company can borrow foreign loans either from foreign banks or from its foreign shareholders without first obtaining approval from either NDRC or SAFE.

It shall be noted that unlike a foreign-invested LLC, a foreign-invested company limited by shares may often find themselves having no foreign debt quota because the total investment amount is not required to be made clear in the process of incorporating a foreign invested company limited by shares, thus resulting in no difference between total amount and registered capital. So in practice, a foreign-invested company limited by shares shall have to apply to competent local department of commerce to determine the amount of total investment in order to have a foreign debt quota. It is highly advisable that upon incorporating a foreign-invested company limited by shares, promoters shall make clear the amount of total investment.

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The ability of foreign-invested companies to tap international financial market is a clear advantage of such foreign-invested companies that often outperform their Chinese counterparts in the same industry.

III. Registration of Foreign Debts

Registration of foreign debts refers to the report and filing of the foreign loan contracts/agreements together with a term sheet of the contract/agreement, as well as any withdrawal, repayment and conversion of the foreign loan. Amendments to the foreign loan contract/loan shall also be registered after the initial registration thereof.

Banks that borrow foreign loans can now register their foreign debts via their IT system connected to SAFE.

Non-banking borrowers (those domestic companies or foreign-invested companies) shall conduct the registration within 15 days of execution of the foreign loan contract/agreement.

Compulsory registration of foreign debts is a way China controls and manages its foreign debts. In practice, a foreign debt without proper registration will invite serious trouble/penalty for both the banks and the debtors.

IV Conversion and Use of Foreign Debts

Conversion of foreign loan proceeds is strictly restricted until recently China has started to allow voluntary conversion of foreign loan proceeds as promulgated in its Decree No. 16 in June of this year, entitled "*??????????????????*" or "Notice on the Reform and Normalization of Polices on Conversion of Capital Account Foreign Exchange".

Before the new Decree No. 16, only foreign invested companies in China can apply to convert its foreign debt proceeds into RMB and use the same in its business operation. Other foreign debt borrowers such as banks and domestic enterprises are not permitted to convert the loan proceeds into RMB at all. Even the foreign-invested companies are not allowed to keep the converted RMB for long, which shall be paid immediately to counterparties that are supposed to receive the amounts.

With the trial measures concerning voluntary conversion of capital account foreign exchange fund proving to beneficial and manageable, the new Decree No. 16 takes one big step forward by allowing both foreign-invested company and domestic enterprises to convert the foreign debt proceeds at such as time as they see fit.

As a general rule, a short-term foreign debt fund cannot be used for fixed-asset investment or other similar long-term usage but for supplementing its working capital.

There are a lot more to talk about in this regard. We will discourse on it in next post soon.

V **Repayment of China Foreign Debts**

Once a foreign debt is properly registered, the repayment is quite straightforward. The debtor no longer needs to obtain a permission from local SAFE office but to repay the debt directly through banks.

Debtors can either repay the loan with the foreign exchange accumulating in its business or purchase foreign exchanges to repay the loan.

Prepayment of loan is possible so long as it is done pursuant to the terms of the foreign loan contract and both lender and debtor agree on that.

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Author
admin

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