Cross-border Financing: offshore loan against onshore security

Description

With more and more Chinese companies going overseas for acquisition of foreign assets or equities, China State Foreign Exchange Administration (the "**SAFE**") has gone in line with the tide by facilitating cross-border financing whereby it has reorganized its rules on cross-border security or guarantee. In May, 2014, SAFE issued its restated regulation on cross-border securities, titled "*Regulatory Provisions on Foreign Exchange related to Cross-border Securities*" in substitute for the old rules.

This new SAFE cross-border security rules mark a new mindset of regulation this outbound guaranty relaxing substantially the restriction of providing such security to a foreign creditor.

The new rules cover all types of cross-border securities/guarantees that may lead to the cross-border money flow or transfer of asset ownership which are further categorized into three categories: (1) onshore security offshore loan, or in Chinese Nei Bao Wai Dai (????); (2) offshore security onshore loan, or in Chinese Wai Bao Nei Dai (????); and (3) other cross-border securities. The first two categories are the main focus of the regulation because these two can affect the balance sheet of China's foreign exchange assets.

This post is only discussing the "onshore security offshore loan" transactions.

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Creditor (financial institutions) <————> debter [*Offshore*]

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Security provider [*Onshore*]

From the chart, the so called "onshore security offshore loan" refers to the security provided by an entity (including Chinese individuals) in China for purpose of securing a debt/obligation (typical of a bank loan) incurred by an offshore debtor with an offshore creditor.

(1) the security provider or guarantor can be either a Chinese company (meaning a company incorporated in China in accordance with Chinese laws) or a Chinese citizen (natural person), firstly allowing individuals to serve as guarantor for an offshore debt.

(2) the new rules do not require the guarantor to have equity relationship with the offshore debtor, but require that foreign exchange authority shall look into and review the authenticity, commercial reasonableness, compliance and tendency of guarantee being called on and may request the guarantor to explain any question in writing. In the past, Chinese onshore security provider can only provide guarantee to their offshore affiliated companies.

(3) an important point that may need clarification from atop is related to the question: whether the "loan" (as literally translated from the Chinese "?") as used in the "onshore security offshore loan" includes a non-financing obligation. Literally, a loan is a financing obligation. However, it is my opinion that the loan here covers some non-financing obligations such as bidding deposit, contractual performance liability. In the ancillary implementing rules, the cross-border security is also classified into "financing obligations" referring to bank loan, corporate bond, financial lease and the like, and the "non-financing obligations" referring to other general obligations, and also in the section of the implementing rules concerning "onshore security offshore loans", one of the articles mentions such security for construction project completion obligation.

Procedural Formalities for Onshore Security Offshore Loan

(1) unlike the old rules regarding outbound security for offshore debts whereby the guarantor shall seek the consent from foreign exchange authority before entering into security contracts, the new rules allow the parties to conclude the security contracts in the first place and then register the contract with foreign exchange authority. A bank guarantor will easily register through their IT system connected to SAFE, and other non-bank guarantors shall registered within 15 days of the conclusion of the security contracts.

(2) if the debtor pays off or otherwise discharges its own debts or obligations, or the security obligation expires, or the security is called on and realized by creditors, then the guarantor shall effect the deregistration of the aforesaid registration.

(3) in the event the security is called on by creditor, bank guarantors can just follow relevant forex rules to pay money to creditors, but for non-bank guarantors, it shall take the registration certificate obtained in the step (1) to the bank to purchase foreign exchange and pay the same out to foreign creditors.

(4) upon fulfilling the security obligations, the onshore guarantors shall register the credit (against the foreign debtors) with foreign exchange authority.

Substantive Points of Attention

In practice, when engaged in cross-border security, the following points shall be taken into account:

(1) the major point is that SAFE imposes restriction on the use of the fund of the offshore loan proceeds. First of all, the fund so obtained shall only be used for relevant expenses within the debtor's normal business scope (it could be hard for SAFE to assess what normal business scope is when a foreign debtor does not have a well-defined business scope), and shall not be used in any transactions outside of the said normal business scope or used in any speculative transactions. Secondly, the funds, without the approval of SAFE, shall not be repatriated by the debtor directly or indirectly into China for purpose of loaning (debt investment), equity investment or securities investment. It is further provided that such funds shall not be used by foreign entities or individuals to directly or indirectly make the fund available with Chinese entities or individuals for either equity or debt investments, including but not limited to:

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(a) the debtor uses the money directly or indirectly for equity or debt investment into an entity incorporated within China;

(b) the funds are directly or indirectly used for acquiring shares in a foreign company half of whose assets are within China;

(c) the funds are used to repay the debts incurred by the debtor itself or by other foreign company and the finance proceeds of the said debts has already been directly or indirectly repatriated into China for equity or debt investments.

(d) the debtor uses the funds to make advance payments to entities within China in relation to goods or services trade and such advances is more than one year ahead of the provision of goods or services and the amount of advances is more than USD one million and accounts for more than 30% of the total price of the trade contracts.

(2) In case that the onshore security is called on by the offshore creditor and the onshore guarantor assumes the guarantee liability, then before the foreign debtor reimburses the onshore guarantor, the non-bank guarantors cannot sign any new similar security contracts without prior approval from SAFE.

In practice, there is another way of using onshore “guarantee” for offshore financing, which is also called “Nei Bao Wai Dai” (onshore guarantee offshore loan) whereby the Chinese entity (usually corporate entities excluding individuals) deposits a sum of money in RMB with a bank in China and then this bank will get their overseas branch office to extend certain amount of loans denominated in USD or other hard currencies for purpose of investments in offshore markets. But strictly speaking, there is a big difference.

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Clients that are interested to know more about the cross-border security deals may contact the blogger for more.

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