

## SAFE Relaxes Control over Provision of Cross Border Security

### Speed read

On 19 May 2014, the State Administration of Foreign Exchange (**SAFE**) released the long awaited Foreign Exchange Administrative Provisions on Cross-Border Security and its implementation guidelines (collectively the **New SAFE Regulations**). The New SAFE Regulations will take effect on 1 June 2014 and will supersede a series of regulations previously issued by SAFE and bring substantial changes to the current cross-border security regime (also known to some as the foreign security regime).

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This bulletin highlights the key changes to the current regime, features of the new regime, as well as some additional structuring options.

For the purpose of this bulletin, **security** includes both proprietary security and guarantee, and security provider shall be construed accordingly; and **onshore** means mainland China, and **offshore** means outside mainland China.

# Key Changes and New Features Highlighted

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## 1. WHAT IS CROSS-BORDER SECURITY?

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Cross-border security includes:

- a. security provided by an onshore security provider for a debt owed by an offshore debtor to an offshore creditor (*neibaowaidai* or 内保外贷 in Chinese);
- b. security provided by an offshore security provider for a debt owed by an onshore debtor to an onshore creditor (*waibaoneidai* or 外保内贷 in Chinese); and
- c. other types of security which may result in cross-border payment or cross-border title transfer of collateral.

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## 2. WHO CAN PROVIDE/ACCEPT CROSS-BORDER SECURITY?

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### (a) *neibaowaidai* (内保外贷)

For *neibaowaidai*, the New SAFE Regulations remove the requirements for pre-approval, quota limitation and other qualification requirements in connection with the debtor, including all financial tests (in terms of, for example, profitability of the debtor) and shareholding of the security provider in the debtor. Such relaxation applies to all types of security providers. The New SAFE Regulations also expressly allow onshore individuals to provide *neibaowaidai* alone, whether or not a corporate security provider is also involved in the transaction.

In other words, onshore financial institutions qualified to engage in security provision business, onshore corporates and individuals are all free to provide *neibaowaidai* under the new regime.

### (b) *waibaoneidai* (外保内贷)

Any onshore financial institution which provides a loan (excluding entrustment loans) or a committed credit facility (有约束力的授信额度) to an onshore non-financial institution can accept *waibaoneidai*.

Other than the above, any other entity is restricted from accepting *waibaoneidai* unless otherwise approved by SAFE.

**(c) other types of cross-border security**

The New SAFE Regulations do not expressly set out any specific requirement or restriction on who can provide/accept other types of cross-border security. Given that SAFE now only requires registration for cross-border security under the *neibaowaidai* and *waibaoneidai* structures, it can be reasonably concluded that, from SAFE's perspective, all onshore entities are free to provide/accept other types of cross-border security.

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**3. WHAT ARE THE "PERFECTION" REQUIREMENTS?**

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The New SAFE Regulations now only require post-event registration of the cross-border security with local SAFE under the *neibaowaidai* and *waibaoneidai* structures. Details of the relevant registration requirements are set out in Appendix 1. No SAFE registration is required for other types of cross-border security unless otherwise explicitly required by SAFE.

Subject to the exception mentioned in Appendix 1, enforcement of any properly registered cross-border security under a *neibaowaidai* or a *waibaoneidai* structure would no longer require prior SAFE verification.

Note, however, that registration of cross-border security with SAFE is no longer a "perfection" requirement. The New SAFE Regulations have helpfully clarified that failure to carry out any approval, registration or filing (if required for a type of cross-border security under the New SAFE Regulations) will not impact on the validity of the security.

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**4. DOES THE RESTRICTION ON REPATRIATION OF PROCEEDS STILL APPLY?**

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Yes. Notwithstanding that the approval/registration requirements have been largely relaxed, restriction on the repatriation of proceeds of an offshore debt under a *neibaowaidai* structure still applies. Those proceeds may not be repatriated, whether directly or indirectly, from offshore to onshore, whether by way of equity investment or lending (which includes direct or indirect equity investment in an offshore company where 50% or more of its assets are located in the mainland China).

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**5. IS THERE ANY IMPLICATION IF THE ONSHORE SECURITY PROVIDER (IN CASE OF NEIBAOWAIDAI) OR THE OFFSHORE SECURITY PROVIDER (IN CASE OF WAIBAONEIDAI) IS NOT REIMBURSED IN FULL BY THE DEBTOR AFTER ENFORCEMENT?**

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Yes, until the security provider is fully reimbursed by the debtor after enforcement of a cross-border security, the relevant onshore security provider (other than a bank) under a *neibaowaidai* structure would be restricted from providing further cross-border security for *neibaowaidai*, and the relevant onshore debtor under a *waibaoneidai* structure would be restricted from borrowing any new loan backed by *waibaoneidai*.

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**6. CAN NEIBAOWAIDAI SECURE A DERIVATIVE TRANSACTION?**

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Yes, provided that the underlying derivative transaction is entered into by the debtor for hedging purpose, in line with its business scope and is duly authorised by its shareholder(s).

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**7. CAN NEIBAOWAIDAI SECURE OFFSHORE BOND ISSUANCE?**

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Yes, provided that (a) the issuer is directly or indirectly owned by an onshore entity; (b) the proceeds of the bond issuance shall be used for an offshore project in which the onshore parent of the issuer has an equity interest; and (c) the issuer and such offshore project have been duly approved by, registered and filed with, the relevant authorities in charge of outbound investment. The removal of quota or approval requirement for *neibaowaidai* is certainly a welcome change in the context of an offshore bond issuance, as a direct guarantee by the onshore parent of the offshore issuer would be a much "cleaner" solution than the current market practice of obtaining keep-well letters from the onshore parent. However, it remains to be seen whether the restriction on the usage of funding to a particular project (rather than the widely seen "general corporate purpose" type of usage), which is not required under the existing SAFE regime, would reduce the appetite of the issuer's group to adopt this structure.

# What It Means in Practice

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## 1. NEW STRUCTURING OPTIONS

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The New SAFE Regulations bring ample opportunities for loan market participants to explore and develop new structures for cross-border financing. We set out below a few examples.

### (a) Outbound acquisition financing

Before the New SAFE Regulations come into effect, a typical outbound acquisition financing (see diagrams 1 and 2 in Part 1 of Appendix 2) is usually backed by a guarantee (which is subject to having sufficient SAFE quota or SAFE's case-by-case approval) or, where such quota and approval are not available, some form of keep-well arrangement provided by the borrower's onshore parent. In some cases, lenders would require a letter of credit (L/C) to be issued by an onshore bank in support of the offshore financing.

The existing structure has a few downsides, including, for example, the difficulty in obtaining a SAFE quota or SAFE's approval for the onshore parent's guarantee, the additional costs that the borrower will need to incur where a L/C is required and the complications for big ticket deals where more than one L/C issuing banks need to be involved due to the limitation on individual bank's quota to issue such L/C.

Under the New SAFE Regulations, the offshore lenders can benefit directly from security provided by the onshore parent or any other onshore company (whether intra-group or not), as illustrated in diagram 3 set out in Part 1 of Appendix 2. As mentioned above, such cross-border security under a *neibaowaidai* structure is no longer subject to any shareholding requirement, financial criteria, quota or approval. The only remaining formalities are the registration of the cross-border security with local SAFE after signing and the overseas credit registration with local SAFE after enforcement.

### (b) Inbound secured financing

Before the New SAFE Regulations come into effect, under a typical onshore-offshore two-tier inbound secured financing as illustrated in diagrams 1 and 2 set out in Part 2 of Appendix 2), the offshore lenders would find it difficult to structure around the following issues:

- structural subordination of the offshore lenders with no direct access to or benefit from the onshore assets pool/security package;
- cash trapped onshore with limited ways to transfer the cash offshore; and
- no cross-border sharing of enforcement proceeds.

Under the New SAFE Regulations, the offshore lenders can now take security over onshore assets directly to secure the offshore debt, and offshore and onshore groups of lenders can also share security over onshore assets, subject to the restriction on repatriation of proceeds mentioned above. Please refer to diagrams 3 and 4 in Part 2 of Appendix 2 for reference.

**(c) Cross-border derivative transactions**

Under existing SAFE regime, security interest arrangement is not a common option under an ISDA Master Agreement between offshore entities and onshore counterparties due to practical issues with SAFE registration. Given the nature of derivative transactions, it is difficult to specify a secured amount as the exposure of the parties (mark-to-market) is subject to frequent changes. In practice, this has created difficulties in registering the security interest with SAFE. Failure to complete the SAFE registration may have an impact on validity of the security. Under the New SAFE Regulations, security interest arrangements under a CSA will be categorised as other types of cross border security which are not subject to SAFE registration. This new development would have a significant impact on the consideration of the counterparties in determining the use of a New York law CSA or an English law CSA in cross border transactions.

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## **2. IMPACT ON EXISTING DEALS**

In leveraged transactions where all subsidiaries of the target group are required to accede as new security providers to the extent permissible under applicable laws, it now becomes feasible under the New SAFE Regulations for onshore subsidiaries to accede to the finance documents and provide guarantee or security over their assets, subject to the restriction on repatriation of proceeds mentioned above.

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# **Issues to be Further Clarified**

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## **1. CROSS-BORDER SECURITY IN RMB**

The New SAFE Regulations remain silent on one frequently asked question, which is whether SAFE's regulations and requirements relating to cross-border security also apply to cross-border security denominated in RMB. This issue still needs to be further clarified by the authorities.

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## 2. SCOPE OF RESTRICTION ON REPATRIATION

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It remains to be seen to what extent the restriction on repatriation of proceeds will apply in transactions where the proceeds are not used towards any of the restricted purposes expressly set out in the New SAFE Regulations, but, for example, are used to replenish the borrower's own funds which may have been directly or indirectly repatriated onshore.

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## 3. ADDITIONAL DUE DILIGENCE/MONITORING REQUIREMENTS

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The New SAFE Regulations provide that, in case of *neibaowaidai*, the onshore security provider shall (a) check, among other things, the debtor's credibility, funding purpose and repayment sources, and whether the transaction is in compliance with applicable laws and regulations, and (b) monitor the debtor's use of proceeds from the relevant financing. It is questionable how a corporate security provider, which may not have sufficient resources and experience, will be able to comply with such due diligence and monitoring requirements.

## Conclusions

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The New SAFE Regulations are likely to fundamentally change the landscape of any financing involving onshore credits and onshore assets. They will introduce simpler and cleaner financing structures. They also brought much needed legal certainty to the validity and enforceability of cross-border security. This, coupled with the recent development in other areas such as the group cash-pooling arrangement in the Shanghai Free Trade Zone and RMB internationalisation, is likely to help many MNCs, Chinese and foreign alike, to access more funding options and to tap into cheaper funding sources much faster.

## APPENDIX 1

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### CROSS-BORDER SECURITY - REGISTRATION REQUIREMENTS

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Registration applicable to *neibaowaidai* and *waibaoneidai* include:

(a) *neibaowaidai*:

- after signing, security registration by the onshore security provider; and
- after enforcement, overseas credit registration (对外债权登记) by the onshore security provider in respect of its subrogation claim against the offshore debtor.

Note that in the case of any *neibaowaidai* under which the secured amount cannot be reasonably determined on day one (e.g. a completion guarantee without a definite maximum compensation

amount), no registration is required after signing but enforcement will be subject to local SAFE's prior verification.

(b) *waibaoneidai*:

- after signing, no registration; and
- after enforcement, short-term foreign debt registration by the onshore debtor in respect of the offshore security provider's subrogation claim against the onshore debtor.

## APPENDIX 2

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### NEW STRUCTURING OPTIONS

#### PART 1 - Outbound Acquisition Financing

Diagram 1: Existing Structure 1

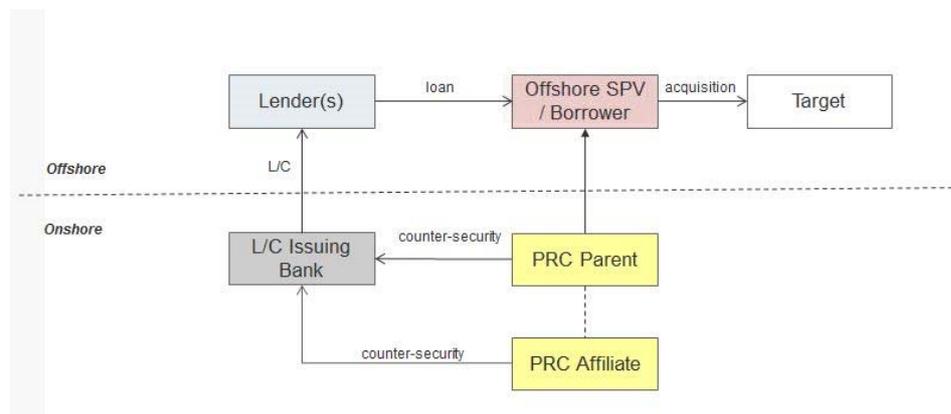


Diagram 2: Existing Structure 2

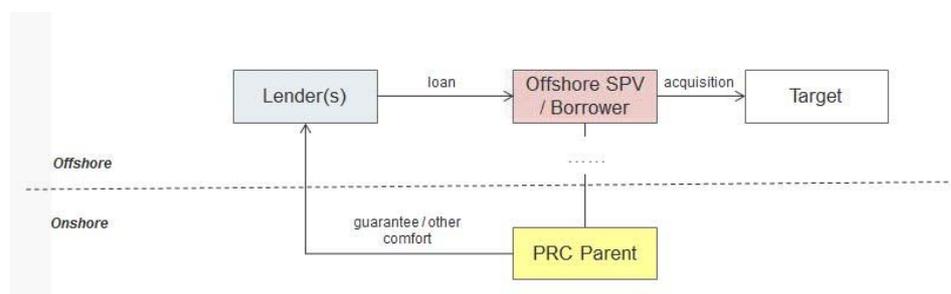
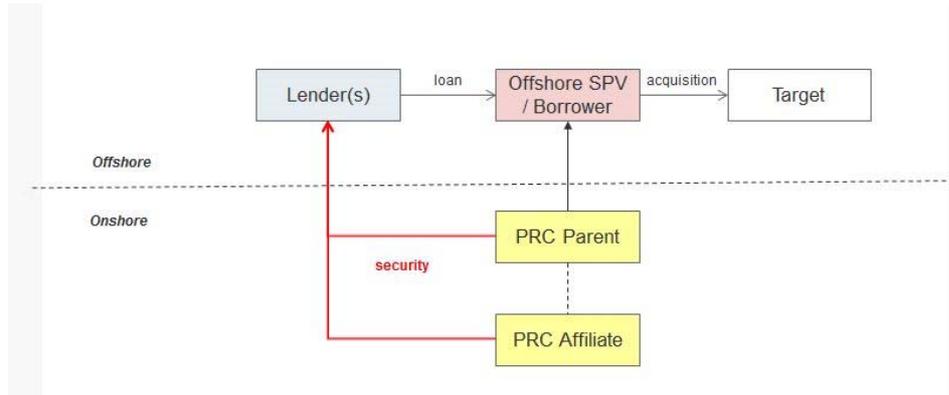


Diagram 3: Alternative Structure



PART 2- Inbound Secured Financing

Diagram 1: Existing Structure 1

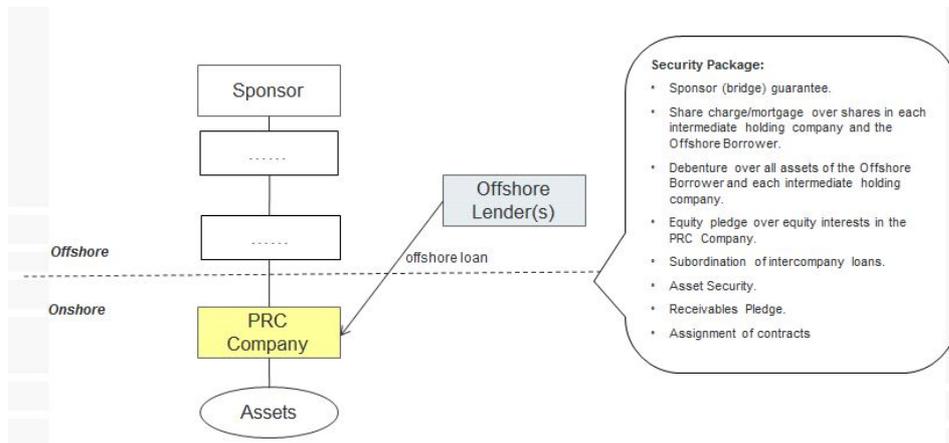


Diagram 2: Existing Structure 2

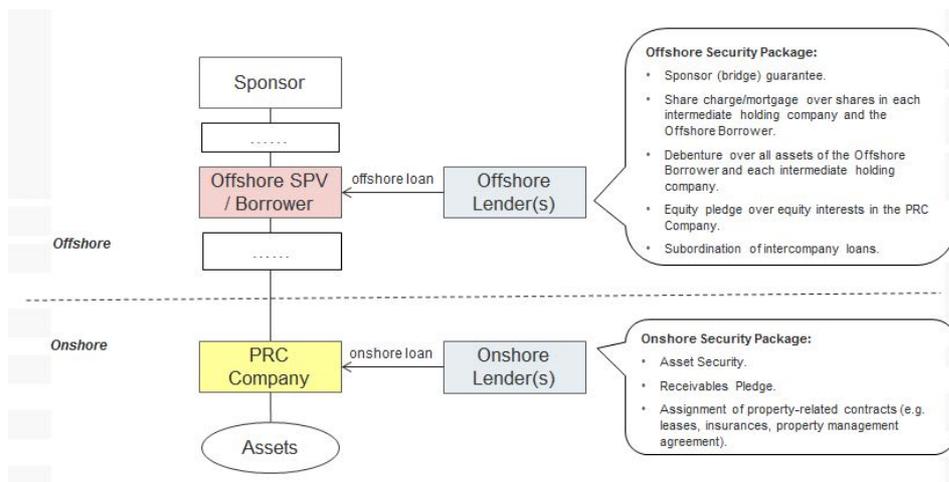


Diagram 3: Alternative Structure 1

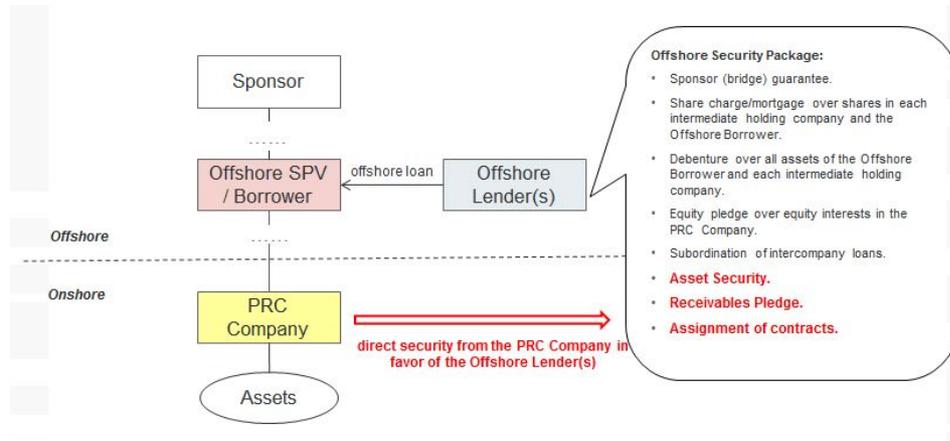
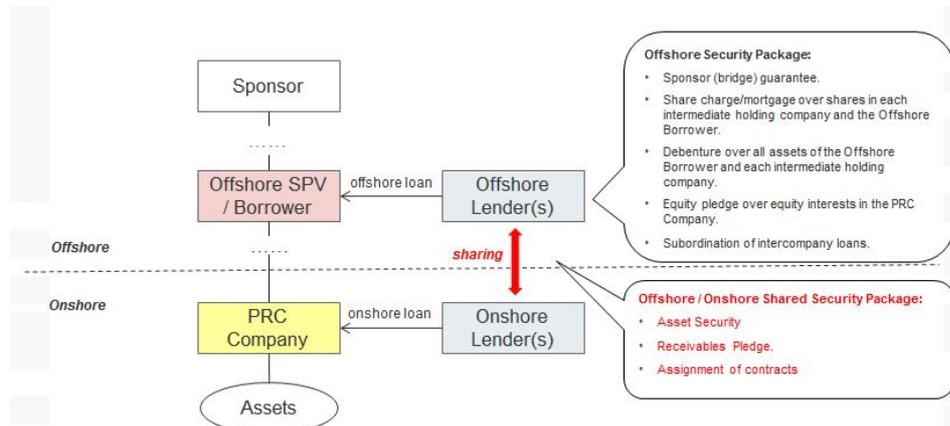


Diagram 4: Alternative Structure 2



\*Note: Under both alternative structures set out in diagram 3 and diagram 4 above, the provision of the offshore loan is subject to the restriction on repatriation of proceeds.

## Contact information

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