

# CHANGES TO THE PRC'S STATE ADMINISTRATION OF FOREIGN EXCHANGE (SAFE) RULES:

## A NEW DAWN FOR THE PROVISION OF CROSS- BORDER GUARANTEES AND SECURITY?

**The purpose of the SAFE Rules, applicable to guarantees and security, has always been to monitor, and in the past limit, the giving of cross-border guarantees or security. This was ostensibly to control large capital flows into and out of the People's Republic of China (PRC) (such foreign exchange controls being common in developing countries). As the PRC economy matures, and indeed acts as the world's growth engine, the SAFE Rules are unsurprisingly relaxed.**

The "Foreign Exchange Administration Regulations on Cross-Border Guarantees and Security" (跨境担保外汇管理规定) (Regulations) and corresponding operation guidelines (together the Rules), have been recently issued to improve the administration of cross-border guarantees and security, and promote healthy and orderly development of the operation of cross-border security and guarantees. The Rules apply as of 1 June 2014, and make it significantly easier for cross-border guarantees and security to be provided, in particular, by onshore guarantors or security providers. Crucially, prior registration of cross-border guarantees and security with SAFE is no longer required to ensure their validity from a foreign exchange control perspective.

This Briefing provides an overview of the changes brought about by the Regulations and provides insight into how the Regulations may affect the shipping industry.

### **Definition of "Cross-Border Guarantees and Security" and categorisation under the Regulations**

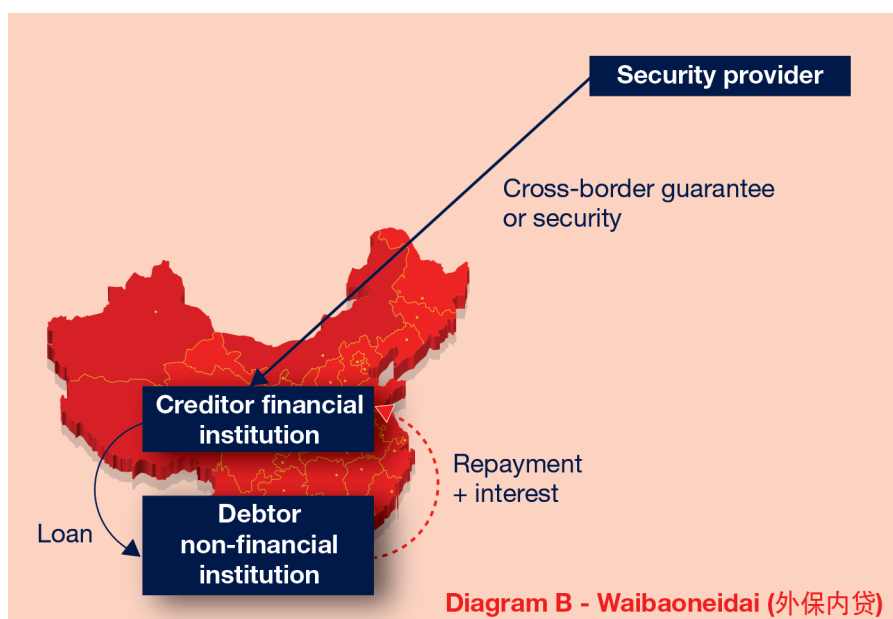
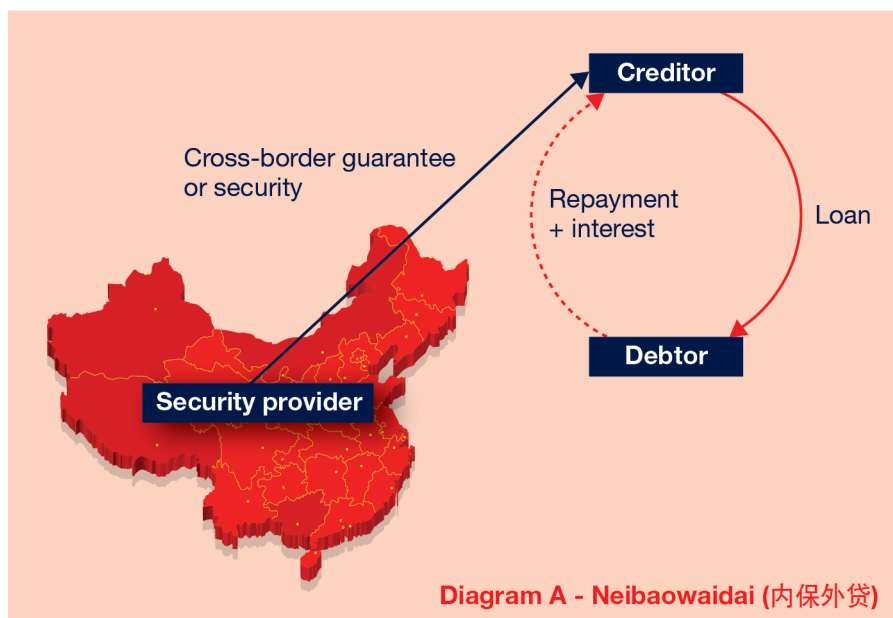
Cross-border guarantees and security (跨境担保), which are regulated under the Regulations, refer to acts of guarantee or provision of security, involving a written binding commitment by the guarantor or security provider in favour of the creditor to pay. The written binding commitment must be in accordance with the relevant guarantee or security agreement and may result in cross-border payments and receipts, transfer of property titles, or other transactions affecting the PRC's balance of payments. The definition is important as it clarifies which activities are subject to monitoring and/or regulation by SAFE, and which activities are not. This is helpful as there was much uncertainty before the introduction of the Regulations.



The Regulations divide the provision of cross-border guarantees and security into three categories, which we demonstrate graphically here using the example of a loan (but it is easy to read “charterer” in the place of “debtor” and owners in the place of “creditor” so as to analyse a guarantee given in respect of a charterer’s obligations under a charterparty). It is worth noting that for the purpose of the Regulations, Hong Kong and Macau are considered “offshore”, as these territories are run under the one country, two systems model.

1. **Neibaowaidai (内保外贷):** This refers to the provision of cross-border guarantees or security by an onshore security provider to an offshore creditor, to secure the debts of an offshore debtor. Diagram A (right) illustrates how neibaowaidai functions, using an offshore loan as an example.
2. **Waibaoneidai (外保内贷):** This refers to the provision of cross-border guarantees or security from an offshore security provider to an onshore financial institution (creditor), to secure the debts of an onshore non-financial institution (debtor). Diagram B (right) illustrates how waibaoneidai functions, using an onshore loan as an example.
3. **Others (其他形式):** This refers to all other forms of cross-border guarantees and security (which accord with the definition used under the Regulations) that do not fall into categories (a) and (b) above. For example.

- Security provided by an onshore company to secure either its own offshore debts or the debts of other onshore companies (see Diagram C (i)).
- An offshore P&I Club guarantees the performance of a PRC onshore shipowner to an offshore creditor (see Diagram C (ii)).

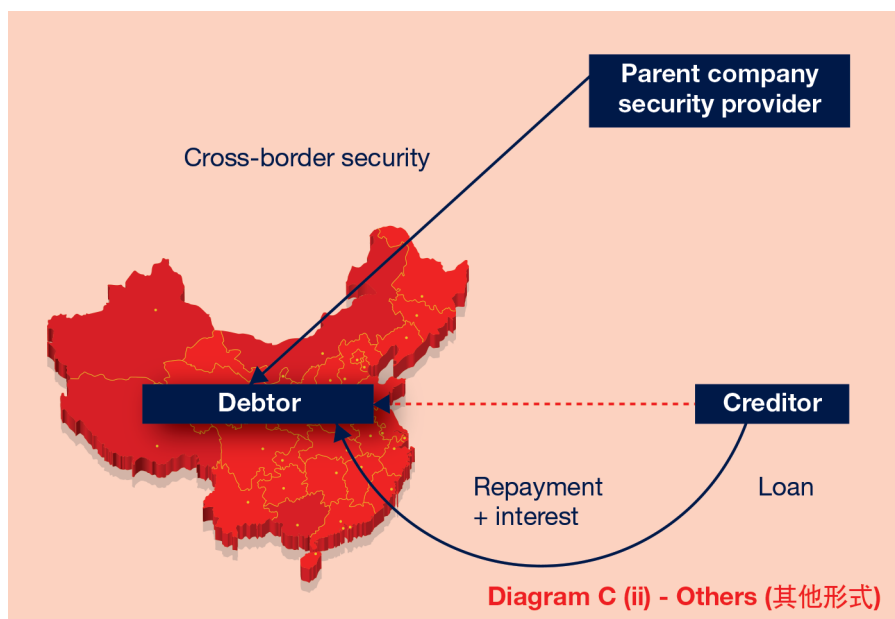
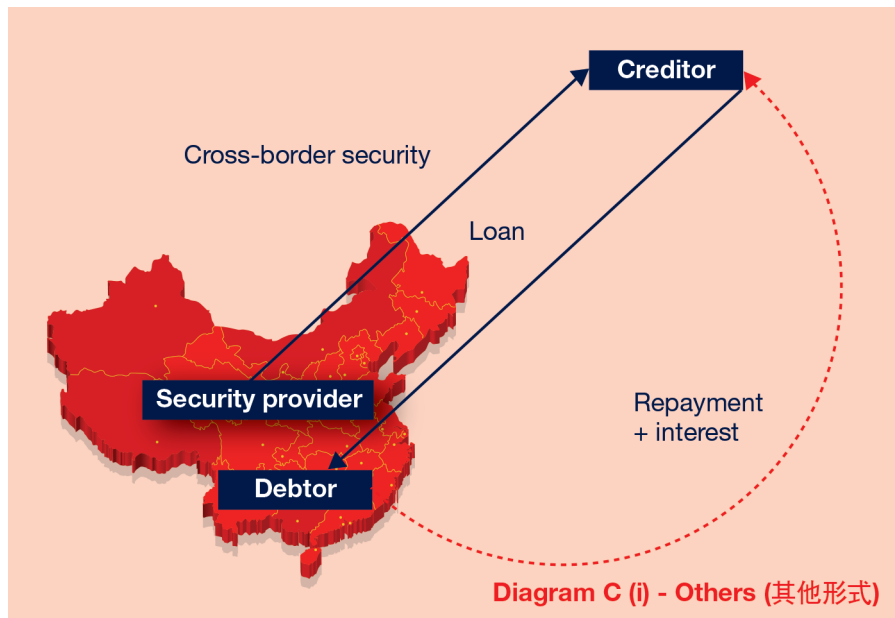


### Neibaowaidai (内保外贷)

#### Previous position

In the recent past, the provision of cross-border guarantees or security by onshore, non-bank financial institutions, corporate and individuals required prior approval from SAFE. For onshore banks, there was a quota system in place that limited the amount of cross-border guarantees and security that could be provided. The old system caused significant

difficulties and delays in the provision of cross-border guarantees and security. It also meant that where a cross-border guarantee or security was provided, without prior approval from SAFE, the security provider could later try to argue that the cross-border guarantee or security was invalid for lack of prior approval. In practice, this meant that an onshore security provider could try to argue when the cross-border guarantee or security was called upon, that he would



exposed shipowners (and often offshore companies relying on cross-border security provided by onshore companies) to potentially huge losses or haircuts when the cross-border guarantee or security was called upon and the charterer's onshore security provider had failed (as was often the case) to register the cross-border security.

#### Position under the Regulations

Non-bank financial institutions, companies and individuals no longer have to obtain prior approval from SAFE to provide cross-border guarantees or security, insofar as foreign exchange control is concerned. Requirements as to the financial status of the guarantor or security provider and shareholding requirements have been removed. Banks are no longer subject to the quota requirement previously imposed by SAFE. Instead, the Regulations focus on the need to subsequently register the cross-border security or guarantee. There remain however, some restrictions (such as the use of funds, which the security provider is expected to monitor, and the restriction on repatriating proceeds into mainland China).

■ **Registration:** Once the cross-border guarantee or security documents have been executed, the guarantor or security provider must register the cross-border security with SAFE. For banks, the data is submitted to SAFE via an online system. For non-bank financial institutions, companies and individuals, registration of the cross-border security or guarantee with SAFE must be effected within 15 business days of the execution of the cross-border guarantee or security documents. The operational guidelines to the Regulations outline the information that must be submitted. Registration with SAFE is also required when there are changes to the terms of the agreement(s) that

not be able to obtain the relevant authorities' permission to transfer the funds required to honour the cross-border guarantee or security, because the cross-border security was unregistered.

The English High Court case *Emeraldian Limited Partnership v Wellmix Shipping Limited, Guangzhou Iron & Steel Corporation Limited*<sup>1</sup> perfectly illustrates the challenges faced by shipowners where a

guarantee was granted by an onshore guarantor on behalf of charterers, without prior approval for the guarantee having been obtained from SAFE. It was submitted in that case that "in the absence of such approval [from SAFE] the guarantee was null and void and a penalty of 30% of the amount of money unlawfully involved could be imposed." The commercial uncertainty caused by SAFE's stringent rules on the provision of cross-border guarantees or security



creates the guarantee, security or the principle contract.

- **Payment under the cross-border guarantee or security:** For guarantors and security providers that are banks, they can make payments under the cross-border guarantee and security themselves. For non-bank financial institutions, companies and individuals, they can present the SAFE registration documents to banks to process the payment. The onshore guarantor or security provider must then report the foreign debt to SAFE within 15 business days. The foreign debt has arisen because the onshore guarantor or security provider will have (upon payment) a subrogated claim against the offshore debtor. Further, the non-bank guarantor or security provider is not allowed to enter into further neibaowaidai until the offshore debtor has fulfilled all of its obligations owed to the onshore guarantor or security provider under the subrogated claim, or SAFE has granted a waiver.

- **De-registration:** The onshore guarantor or security provider must de-register the cross-border guarantee or security with SAFE, once one of the following occurs:

- The debt is paid in full by the offshore debtor.
- The onshore guarantor's or security provider's obligations to pay have expired.
- The onshore security provider has performed its payment obligations under the cross-border security.

To deregister, banks will use their online system. Other onshore guarantors and security providers have 15 business days to apply to SAFE to cancel the registration of the cross-border guarantee or security.

- **Charterparties:** Charterparties often state that the charterparty is: *"between xxx as owners of the Vessel described below, and yyy, or its guaranteed nominee zzz as charterers"*. This creates a neibaowaidai (category 1) cross-border guarantee in situations where, for example, yyy is a PRC onshore company and the owners and the charterers are both offshore entities. In that case, yyy (the onshore guarantor) must register the cross-border guarantee with SAFE within 15 business days in accordance with the Regulations.

#### Waibaoneidai (外保内贷)

##### Previous position

Only foreign invested enterprises (FIEs) and domestic companies holding special quotas from SAFE were able to obtain onshore loans secured by offshore guarantees or security.

##### Position under the Regulations

Under the Regulations, an offshore guarantor or security provider can provide cross-border guarantees or security to a licensed onshore financial institution for the debts of any onshore non-financial institution without prior approval from SAFE. The cross-border guarantee or security can only be provided to secure a loan (either in RMB or a foreign currency, but excluding an entrusted loan) or a line of credit provided by the PRC (onshore) financial institution. The provision of cross-border guarantee or security must also conform to other domestic and foreign laws and regulations (in addition to those set under the Regulations).

- **Registration:** The onshore financial institution is required to report the transaction to SAFE.

- **Enforcement:** If the cross-border guarantee or security is enforced, the onshore debtor must register the foreign debt with SAFE within 15 business days. This is because the offshore guarantor or security

provider now has a subrogated claim against the onshore debtor for the debt. The Regulations impose certain limits on the amount that the onshore debtor can reimburse the offshore guarantor or security provider after the cross-border guarantee or security is enforced. Those limits are linked to the net asset amount plus, in the case of a FIE, its available borrowing gap and, in the case of an onshore entity, its approved foreign debt quota. The onshore debtor must provide information to SAFE so that the debt can be registered. The information to be submitted is outlined in the operational guidelines to the Regulations and include the debtor's last annual unaudited financial statement. Further, the onshore debtor will not be allowed to obtain further waibaoneidai until it has repaid the offshore security provider or obtained a waiver from SAFE.

#### Other forms of cross-border guarantees and security (其他形式)

If the cross-border guarantee or security (as defined under the Regulations) does not fall into the above two categories (i.e. neibaowaidai or waibaoneidai), there are no registration or approval requirements from the perspective of foreign exchange control, unless SAFE otherwise specifies (e.g. by issuing new Rules).

##### Shipping

In view of the clearer definition of cross-border guarantees and security, categorisation of neibaowaidai and waibaoneidai and the corresponding guidelines under the Regulations, it appears that the below arrangements (which are common in the shipping industry) do not require registration with SAFE:

- A PRC onshore guarantor (for example a PRC onshore P&I



Club or insurer) guarantees the performance of a PRC onshore shipowner to an offshore creditor.

- An offshore P&I Club guarantees the performance of a PRC onshore shipowner to an offshore creditor.

One may also encounter the situation of an offshore guarantor guaranteeing the performance of a PRC onshore charterer to a PRC onshore shipowner. While this is in line with the definition of *waiabaoneidai*, the current rules under the Regulations for *waiabaoneidai* concern only a guarantee or security provided by an offshore entity in favour of a licensed onshore bank who has made a loan to an onshore non-financial institution. The treatment of these guarantees under the Regulations is therefore unclear.

As with any new rules, it is prudent to closely monitor their application and if necessary ask the SAFE offices to confirm the applicable registration and/or approval requirements under the Regulations in relation to a particular arrangement.

### Inconsistencies in the law

Other existing PRC legislation has not as yet been amended in view of the introduction of the Regulations. For example, Article 6(1) of the Judicial Interpretation of the Supreme Court on Certain Issues Regarding the Application of Guarantee Law of the PRC still states that a foreign guarantee contract will be invalid if it is provided without the prior approval or registration by a relevant competent department. Moreover Article 19 of the Regulation of the PRC on Foreign Exchange Administration still provides that *"...where the scope of business operations of domestic entities requires approval from the relevant authorities in accordance with the regulations of the government, such approval shall be obtained before making the application to the foreign exchange administration agencies..."*.

It is obvious that both of the aforesaid provisions, which technically trump the Regulations, are now in direct conflict with Article 29 of the Regulations, which provides that the validity of the cross-border guarantee or security is not conditional upon SAFE approval, registration or any other administrative requirements. It is expected that further work will need to be done to clarify the situation, and to ensure that the different rules are aligned with each other.

### What to do with old guarantees?

The Regulations do not contain express provisions to deal with cross-border guarantees or security documents executed prior to the effective date of the Regulations. It is therefore unclear whether the Regulations will be retrospective. It has been suggested that additional guidelines might be issued to clarify this in the future. If the parties are still enjoying good commercial relations, one suggestion to avoid an issue arising for the parties in the future, is to re-execute the guarantee or security documents and register them pursuant to the Regulations. In doing so, one should contemplate issues such as consideration (whether there is sufficient consideration to ensure the validity of the new guarantee or security documents; note that there is no similar requirement of consideration under PRC law) and whether re-registration with the relevant asset registry (e.g. aircraft or shares) will be necessary.

If the security provider does not wish to co-operate, re-execution may prove to be more difficult. The cross-border guarantee and security documentation should be reviewed to consider whether there are any further assurance clauses or similar clauses which could be of assistance (i.e. whether the guarantor or the security provider can be compelled to assist).

### Other considerations

The Regulations are helpful in clarifying a number of foreign exchange control issues concerning cross-border guarantees and security, particularly the applicable registration requirements. To ensure that the intended guarantee or security is effective, one should also review other aspects of the arrangement (in addition to SAFE issues) which may be subject to PRC law e.g. those concerning constitution and operation of the onshore entities (creditor, debtor, guarantor, security provider) to see if there are other restrictions on the relevant entities participating in the arrangement. For example, the Regulations specifically state that the Regulations will not affect the law concerning the creation of security over assets and one should conduct one's own due diligence to ensure that the relevant rules, regulations and procedures are complied with.



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