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Deciphering Offshore RMB Loan Financing.

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Trevor Clark, a Partner in our Hong Kong Banking and Projects team, recently gave an interview for the Asia Pacific Loan Market Association Newsletter (Spring 2011, Issue No. 40) on RMB loan financing. This interview was given as part of the APLMA RMB Financing Seminar held in Hong Kong in February 2011.

We set out below the interview as it appeared in the APLMA Newsletter:

"Offshore RMB financing is becoming a red hot topic in Hong Kong, especially in view of the SAR's goal in becoming an offshore RMB settlement center.

"We will continue to encourage overseas enterprises to issue RMB bonds in Hong Kong, solicit more Chinese mainland enterprises to issue bonds in Hong Kong and seek the expansion of channels for enterprises to invest in the Chinese mainland with the RMB capital raised in Hong Kong," said Financial Secretary John Tsang in his recent budget speech.

This renewed focus comes after a successful RMB trade settlement pilot that was unveiled in June 2009. According to Trevor Clark of Linklaters, the pilot was expanded in June 2010 as part of a major step toward liberalization of China's trade with the world. It expanded to 20 areas (from the original five cities), the areas in China which are entitled to receive payments in RMB under the pilot scheme.

A new pilot scheme for RMB settlement in outbound direct investment was introduced in January 2011. Applicable to the same 20 areas, it allows Chinese investors to make direct investments in RMB in overseas companies or projects. In addition, Chinese banks and branches of foreign banks will be able to provide RMB-denominated loans to finance these investments.

The effect of these measures has been a significant build up in RMB deposits held by banks in Hong Kong (over RMB 300bn by the end of 2010, according to HKMA statistics).

No PRC approvals are needed for RMB loans or bond issues, and nor are PRC approvals required for use of the proceeds outside China or for a current account purpose in China. "If proceeds are to be used onshore in China for a

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capital account purpose, then the usual PRC approvals are required," said Mr. Clark.

There are also no limits on the ability for banks to covert RMB offshore. "However, you need to note the HKMA's 25% prudential reserve and the 10% net open position limit." said Mr. Clark.

These new initiatives allow banks outside of China to arrange RMB financing in loans for their corporate clients. These can be provided without the need for approvals from Chinese authorities and proceeds can be used anywhere in the world.

For businesses worldwide, these offer three primary advantages:

- Enables trade settlement with Chinese partners (without the need for approvals);
- Facilitates investment in China businesses (with the necessary approvals);
- Allows access to RMB for treasury purposes.

Offshore RMB loan issues

Although the APLMA loan template can be adapted for use for offshore RMB loans, Mr. Clark stated that it is worthwhile for banks to understand and address the various related issues.

Lack of a benchmark rate

Mr. Clark observed that at present there is no offshore RMB screen rate equivalent to HIBOR/LIBOR. This is seen by many as the main obstacle to the development of an offshore RMB syndicated loan market. Although some banks do offer an offshore RMB prime rate, there is currently no HIBOR RMB screen rate. The onshore and offshore RMB interest rate has diverged. Mr. Clark observed that the APLMA has established a China Working Group to consider how a benchmark rate may be established.

RMB availability concerns

RMB availability may also be a concern for many banks. The main three related issues include:

(i) **Illiquidity**: If the general RMB exchange market becomes illiquid in Hong Kong;

(ii) **Transferability**: If it becomes impossible to deliver RMB between accounts in Hong Kong;

(iii) **Convertibility**: If it comes impossible to convert a foreign currency amount in the RMB exchange market in Hong Kong.

To address this, Mr. Clark advises banks to ensure that RMB is clearly stated as the currency of account in Clause 28.8 (Currency of Account)[1] so that

[1] All clause references in this article are to the APLMA multiple borrower, multiple guarantor, single currency term facility agreement (English law), (version 5 July 2010) unless stated otherwise.

there will be an "event of default" if the payment is not made in the correct amount and the currency, as stated in Clause 21.1 (Non-payment).

There is nothing to suggest that RMB will in fact cease to be available offshore, but this concern has been raised in the RMB bond market, and addressed in some deals through the inclusion of a "fall back clause", which allows the issuer to repay in US$ if RMB ceases to be available.

Using a fallback currency option will require an appropriate exchange rate - Mr. Clark suggested using the CNH screen rate, with fallback to the non-deliverable offshore rate, or the PBOC onshore rate, as seen in some of the bond deals.

Mr. Clark also suggested adopting the "optional" currency approach as seen in the APLMA multicurrency facility agreement template, so that banks are not required to fund in RMB if for any reason RMB ceases to be available.

Specifically, Clause 4.3 (Conditions relating to Optional Currencies)[2] states that the currency needs to be readily available in the amount required and freely converted into US$ and be approved by the Agent. In addition, Clause 6.2 (Unavailability of a Currency)[3] asserts that individual lenders can notify the Agent if the currency, in this case RMB, is not readily available to it, or fund in US$ if providing RMB will contravene a law or regulation.

In addition, Mr. Clark pointed to Clauses 7.1 (Illegality) and 15.2(d) (Other indemnities) as being clauses which further protect the lenders in case it becomes unlawful to fund in RMB or the borrower fails to pay any amount in RMB.

Other issues

A further issue centers on purpose. "That is, restricting the use of proceeds to offshore and onshore current account purposes, or requiring necessary approvals as a condition precedent where proceeds are to be used for onshore capital account purposes," said Mr. Clark.

Capital costs can also be an issue, which is covered by the APLMA documentation in Clause 13 (Increased Costs). On top of the prudential ratio and net exposure requirements, banks need to price in any capital costs upfront. "Only costs arising from <u>changes</u> to regulation are covered by the Increased Costs clause," he said.

The big picture

Mr. Clark sees the above initiatives as a first step in China's plans to internationalise its currency. "These are seen by market commentators as the first steps towards full convertibility of RMB and the liberalisation of its trade regime," he added.

However, he noted that the issues highlighted above - particularly the lack of a benchmark rate for offshore RMB – "will need to be addressed before

[2] APLMA multicurrency term and revolving facilities agreement (English law), (version 9 November 2005)

[3] APLMA multicurrency term and revolving facilities agreement (English law), (version 9 November 2005)

offshore RMB loans become widely seen."

Winston Thomas – Freelance Journalist
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