RMB INTERNATIONALISATION
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KING&WOOD MALLESONS 金杜律师事务所

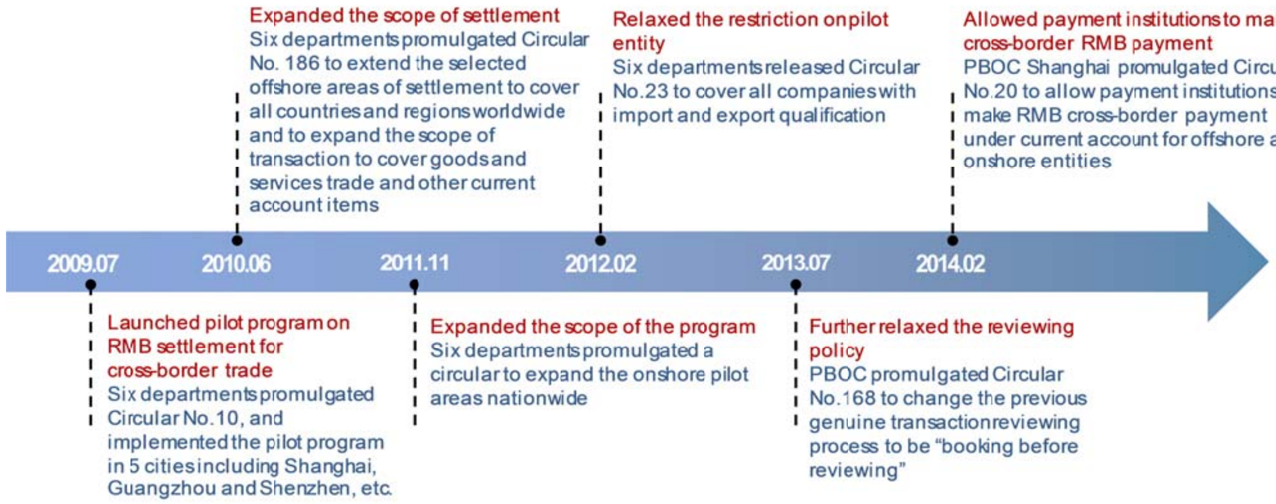
Offshore RMB Backflow Channels

Internationalisation of RMB is an unstoppable trend. China is now the second largest economy and the largest trading nation in the world. To build international recognition of RMB that matches its global economic status, China has introduced a series of laws and policies to internationalise RMB. Initially, RMB was used to settle payments in international trade. Now, RMB is widely used in overseas direct investment and to provide financing and invest in financial markets. All these pave way for RMB to be considered as the next international reserve currency. With the rapid development of offshore RMB markets and the accumulation of substantial RMB funds offshore, how to efficiently use, maintain, and increase the value of RMB funds is now an important issue of internationalization of RMB. It is against this background that the creation and expansion of RMB backflow channels, summarised below, has attracted attention.

1. RMB Backflow Under Current Account

In July 2009, the PRC government launched a small pilot program to permit selected Chinese companies to settle their cross-border trades in select offshore jurisdictions in RMB. The program has expanded and now permits all mainland Chinese companies with import and export qualifications to settle their global transactions for goods, services, and other current account items in RMB, provided the transaction is genuine. Payment channels have also expanded from traditional banks to include third party payment institutions. Use of RMB to settle cross-border transactions helps reduce currency conversion costs, reduce exposure to exchange rate fluctuation, simplify procedures for making payment, and improve the efficient use of funds.

The diagram below illustrates China's progressive changes in this area. The ease of restrictions and attendant benefits has made RMB backflow under current account the most common channel for RMB backflow.



2. RMB Backflow under Equity Investment

Use of RMB to settle cross-border transactions has resulted in the accumulation of RMB under capital accounts offshore. For this reason, regulators in China have endeavoured to establish a channel for RMB cross-border equity investment, as described below. RMB cross-border equity investment not only expands the use of offshore RMB, but is also convenient for onshore invested entities because they no longer must convert foreign currency capital injections to RMB or satisfy foreign exchange restrictions imposed by the State Administration of Foreign Exchange (SAFE).

a. **<u>Foreign direct investment</u>**: In October 2011, the Ministry of Commerce (MOFCOM) issued regulations to allow foreign investors to use legally obtained offshore RMB for foreign direct investment (FDI) in China by means of incorporation, capital increase, merger, acquisition, share purchase, or share transfer. Subsequently, the People's Bank of China (PBOC) also released policies to regulate the use of offshore RMB for FDI. Under current regulations, offshore RMB may be used for FDI provided that the invested entity uses the funds for purposes within its permitted business scope. Such RMB capital injection may not, however, be used to

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invest in securities and financial derivatives, to provide entrusted loans, or to purchase financial products or real estate for commercial use, etc. Despite these relatively limited restrictions, the use of offshore RMB to fund FDI has increased significantly. According to MOFCOM's official website, in 2013, a total of RMB 448.13 billion in offshore capital was used to fund FDI in China.

b. **Investment in financial institution**: In September 2013, the PBOC released policies to allow foreign investors also to use offshore RMB to invest in onshore financial institutions by means of incorporation, capital increase, merger, acquisition, share purchase, and share transfer. Investments in onshore financial institutions are more closely monitored and are subject to approval by the China Banking Regulatory Commission on a case-by-case basis.

c. **Private equity investment**: A third investment alternative for offshore RMB is the RMB Qualified Foreign Limited Partner (RQFLP) program. The RQFLP program permits qualified foreign limited partners to raise offshore RMB and make equity investment within the approved investment quota. This program is still in the pilot stage and is limited to Shanghai. It follows the successful implementation of the foreign currency denominated Qualified Foreign Limited Partner (QFLP) program also in Shanghai.

3. RMB Backflow under RMB Bonds and Foreign Loans

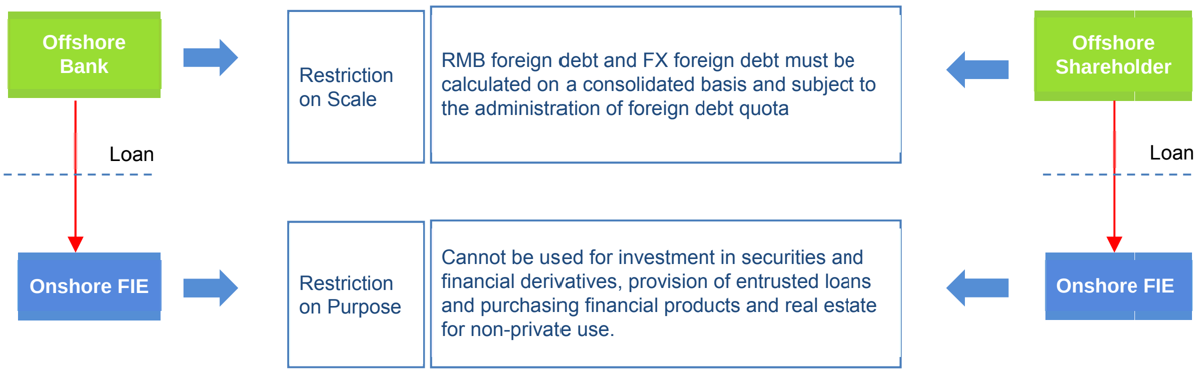
Additional important RMB backflow channels include RMB denominated bonds and foreign debt. Since 2007, onshore financial institutions have issued RMB denominated bonds in Hong Kong. The volume of these bonds has grown steadily which are now issued not only by financial institutions but also by governmental bodies and non-financial institutions. The volume of RMB denominated foreign loans has also increased, as onshore entities increasingly look offshore for funding.

a. **RMB denominated bonds issued by financial institutions**: In June 2007, the PBOC and the National Development and Reform Commission (NDRC) jointly issued a policy to allow onshore financial institutions to issue RMB denominated bonds in Hong Kong and to remit these funds back to China. Only qualified institutions may issue RMB denominated bonds within the approved quotas, subject to PBOC and NDRC approval and SAFE registration procedures for bond capital.

b. **RMB denominated government bonds**: In September 2009, the Ministry of Finance (MOF) and the Government of the Hong Kong Special Administrative Region jointly released a public notice, announcing that the Central Government would issue RMB denominated government bonds totaling RMB 6 billion and would continue to issue these bonds in Hong Kong annually. Funds raised will be used primarily for investment in agriculture, housing, education, healthcare, clean energy, and infrastructure, etc.

c. **RMB denominated bonds issued by non-financial institutions**: In May 2012, the NDRC issued a policy to also allow onshore non-financial institutions to issue RMB denominated bonds in Hong Kong and to remit the funds raised back to China. NDRC approval is also required and the funds raised must mainly be used in from borrowing RMB foreign loans.

d. **RMB foreign loans**: In October 2011, the PBOC issued a policy to allow foreign-invested entities (FIEs) to borrow RMB from offshore lenders, provided that the FIE's registered capital has been timely paid. Onshore real estate enterprises, however, are prohibited from taking out RMB foreign loans.



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4. RMB Investment in China's Financial Markets

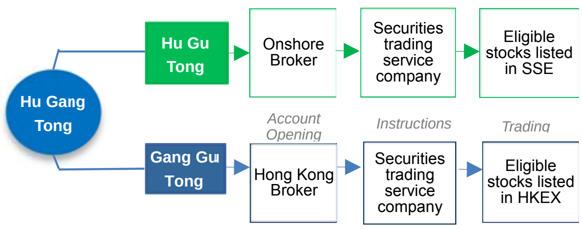
The opening of China's financial markets for offshore RMB investment has a short history. To avoid the inflow of hot money, investment into China's financial markets, whether through the RQFII program or Hu Gang Tong (沪港通), is strictly regulated and investments are subject to approval and quotas.

a. **Inter-bank bond investment**: In August 2010, the PBOC issued policies to allow three types of institutions, including offshore central banks and monetary authorities, RMB clearing banks in Hong Kong or Macau, and banks participating in cross-border RMB trade settlement, to use RMB to invest in the Chinese inter-bank bond market, subject to PBOC approval on a case-by-case basis.

b. **Onshore securities investment**: In December 2011, the China Securities Regulatory Commission (CSRC), PBOC, and SAFE jointly issued a policy to allow Hong Kong subsidiaries of onshore fund management companies and securities companies to apply to become a RMB Qualified Foreign Institutional Investor (RQFII) which may use RMB raised in Hong Kong to invest in onshore securities. In March 2013, RQFII program was expanded and certain restrictions on investment were relaxed.

c. **Stock investment in Hong Kong and Shanghai (Hu Gang Tong)**: In April 2014, the CSRC and Securities and Futures Commission of Hong Kong issued a joint announcement approving a pilot program to allow the Shanghai Stock Exchange and the Hong Kong Exchanges to connect and allow investors in Shanghai and Hong Kong to trade stocks listed on each other's exchanges. Trades on the Shanghai Stock Exchange are limited to RMB 300 billion.

The introduction of the Hu Gang Tong is another significant step to accelerate the backflow of RMB and bridge the flow of capital between Hong Kong and mainland China, offer more investment mechanisms for offshore RMB, and enhance the liquidity of offshore RMB in Hong Kong.



5. RMB Backflow Policies in Pilot Regions

To further progress the internationalisation of the RMB, China has established financial reform pilot programs in areas such as Shanghai, Qianhai, Kunshan and Yiwu. These regions have rolled out innovative policies to stimulate the backflow of RMB, which are summarised in the diagram below.

Kunshan Pilot Area
Mainly includes: Cross-border RMB settlement by individuals under current account and outbound direct investment; Two-way cross-border borrowing among Taiwan-funded enterprise groups; and Settlement of cross-border RMB direct investment in Kunshan by Taiwan-funded financial institutions

Shanghai Pilot Free Trade Zone
Mainly includes: Cross-border RMB settlement under current account and direct investment, RMB settlement account opened by individuals; Offshore RMB borrowing by institutions in the FTZ; Two-way cross-border RMB cash pooling; Centralized cross-border receipt and payment of RMB under current account; RMB settlement of cross-border electronic commerce; and Cross-border RMB trade service transactions

Yiwu
Domestic and foreign individuals may use RMB to settle cross-border transactions involving procurement, service, and other businesses under current account

Qianhai
Enterprises registered and operated in Qianhai may take out RMB loans from offshore lenders to support construction and development of Qianhai. The PBOC Shenzhen adopts administration by balance regarding RMB loans and permits the lender and borrower to determine the terms and interest rates.

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The Shanghai Free Trade Zone (FTZ) is becoming a popular venue for RMB backflow. Its innovative policies, e.g., allowing domestic companies to raise RMB foreign debt, permitting multinational companies to establish RMB cross-border cash pooling, and the introduction of an international board for onshore exchanges such as the China Gold Exchange, have made it an attractive destination for RMB investment.

6. Final Remarks

RMB backflow under current account remains the most common channel of RMB backflow. Though restrictions have eased over the years, RMB backflow under capital account is not as liberalised and administrative requirements concerning qualifications, quotas, and the structure of investment products still apply. The continued development of RMB backflow channels will significantly impact RMB internationalisation and expansion of these channels will be subject to foreign exchange reforms to the allow free conversion of RMB under capital account, establishment of offshore RMB financial centres, expansion of RMB bond trading, and establishing offshore RMB funds.

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