

China Tightens Entrusted-Loans of Commercial Banks

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On 5th January 2018, the China Banking Regulatory Commission (Hereinafter "CBRC") issued the "Notice about commercial banks' management on entrusted-loans" (Yinjianfa [2018] No.2) (Hereinafter "the Notice"¹), aiming to standardize the entrusted-loans business by strictly tightening fund sources and usage of such funding. The Notice takes immediate effect.

BACKGROUND

Under the existing system, direct finance is not allowed between general enterprises in China. Hence, the entrusted-loans via commercial bank are widely exerted as a tool to enhance efficiency of fund operations and lower the financing cost. (Please refer to the diagram below) In recent years, commercial banks have seen a rapid development in entrusted-loans business.

[Diagram] The model of Entrusted-loans



There are some differences in practice due to lack of standardized rules. Although entrusted-loan brought about some positive impacts on real economy, it is faced with hidden risks due to lack of clear and unified regulations.

For instance, some companies without lender license borrow from commercial banks at the benchmark interest rate and relend it to another company at a higher rate through entrusted-loans in order to earn the arbitrage margin, which is not in line with the original intention set by related authorities.

Besides, enterprises such as asset management plan providers take the form of shadow financing and lend money to borrowers designed by commercial banks, bringing entrusted-loans to real estate sector and local government financing platforms that are not subject to the "encouraged industry" in China.

¹ China Banking Regulatory Commission (5th January 2018). Retrieved from: http://www.cbrc.gov.cn/govView_C5E45CCFFFA64632AF0C4391CDAA73B0.html

With the aim of tackling the above situation, CBRC had announced a draft proposal on 16th January 2015. With slight revision, the Notice is officially promulgated in 2018 after approximately 3 years. It is highly expected that the Notice will further strengthen financial risk control and better serve the real economy by regulating the market.

HIGHLIGHTS

I) The positioning of entrusted-loans business and responsibility of each party are specified

The Notice defines entrusted-loans as an agency business for commercial banks. The commercial lenders should neither help confirm the borrower, nor involve in decision-making or provide any kinds of guarantee, for and on behalf of the lender. Moreover, instead of commercial bank, the lender should independently check items such as borrower's credit, projects, usage of funding and bear the credit risk of entrusted-loans.

What's more, entrusted-loans under cash management are not subject to the Notice, which means that intro-group cash-sweeping and funds transfer will not be influenced.

II) Funding sources of entrusted-loans are standardized

The Notice urges commercial banks to commence necessary investigation upon the legitimacy of funding sources for entrusted-loans and regulate such sources.

Key checking items on the lenders:

- Whether the fund source for entrusted-loans exceeds the scope of its normal income and financial ability
- For lenders who has outstanding credit in commercial bank, the bank should reasonably measure self-owned fund of the lender and deem it as key benchmark for entrusted-loans

The sources below are prohibited:

- Funds from fiduciaries;
- Bank credit;
- Special funds created for a specific purpose;
- Other forms of debt capital;
- Funds with unproven sources

Furthermore, if the borrower of entrusted-loans is also the credit customer of the commercial bank, commercial bank should consider the potential risk and impact generated by credit exposure, after the borrower successfully obtains entrusted-loans.

III) Funding usage of entrusted-loans is specified

The usage of entrusted-loans should be in line with law regime, macro-economic management and industrial policies.

Funding usage below is prohibited:

- Funds used to produce, operate or invest on/to usages/areas that prohibited by country;
- Funds used to invest on bonds, futures, derivatives and asset management products;
- Funds used as/for registered capital/capital verification;
- Funds used as equity investment or capital increase (except for those regulated by related authorities);
- Others

IV) Others

- The lender should set up a dedicated bank account for entrusted-loans
- Asset management company and institutions that carries out financing business are not eligible to be lenders

COMMENTS

Overall, the Notice has filled in the blank of the existing system and enhanced processes for checking fund sources and usage of entrusted-loans, which may take enterprises more time on preparation. Enterprises with funding needs are advised to early prepare financing plans upon business strategy. Furthermore, since intro-group cash pooling is out of subject of the Notice, enterprises are also recommended to introduce cash-pooling as one of the ways of intro-group financing.

It is noteworthy that asset management companies who used to be the main lenders of entrusted-loans, such as fund management subsidiaries and private equity investment fund companies, are anticipated to be much affected by the Notice. At the same time, institutions that carry out financing business such as microfinance companies, P2P platforms and non-depository financial institutions such as consumer finance companies and financial leasing companies, may not be eligible to be lenders of entrusted-loans according to the Notice.

On the other hand, since the Notice states that other forms of debt capital are not allowed to be one of the funding sources, it is to be confirmed upon further notice whether FCY-dominated foreign debt can be used on associated company as entrusted-loan after RMB conversion.

Given that a series of new regulations in financial sector has been released recently, China is expected to strengthen financial risk control by continually cracking down on irregular activity and improving related regulations.

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