

### New Rules Set to Encourage Yuan Conversion under Capital Account

EMA TADA  
 BUSINESS DEVELOPMENT OFFICE  
 HONG KONG BRANCH  
 T +852-2823-6091  
 E EMA\_TADA@HK.MUFG.JP

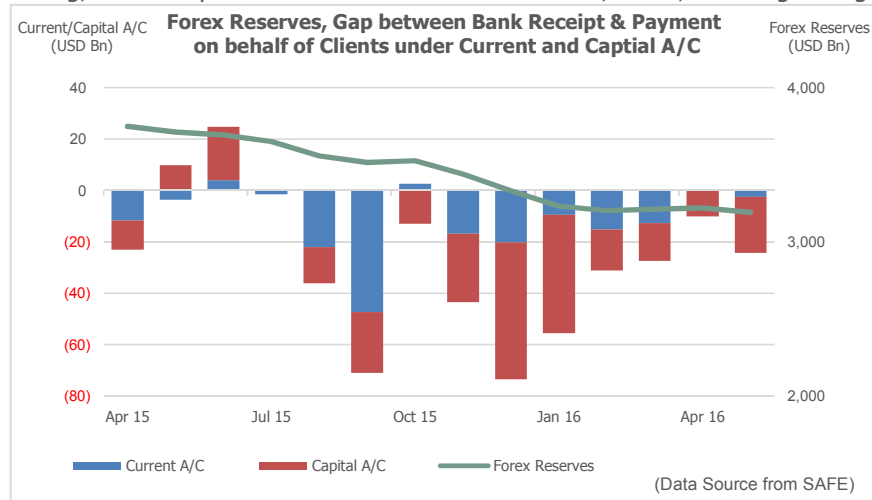
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**The Bank of Tokyo-Mitsubishi UFJ, Ltd.**  
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The State Administration of Foreign Exchange (hereinafter as SAFE) implemented the “Circular to Reform and Standardize Management Rule over Yuan Conversion under Capital Account” (SAFE Circular [2016] 16, hereinafter as New Circular) on 9<sup>th</sup> June, 2016. For all Mainland incorporated non-financial companies, time restriction to convert foreign debt fund into Yuan was removed<sup>1</sup>. The percentage of fund allowed for discretionary Yuan conversion was temporarily set as 100%, but the new circular reserved SAFE’s right to adjust the index in future.

#### BACKGROUND

China’s capital outflow, partly caused by concern over the slowdown of economic growth and its weakening Yuan since September 2014, is pulling down the nation’s foreign exchange reserve. To prevent the reserve from further sliding, SAFE implemented Circular 19 on 1<sup>st</sup> June, 2015, allowing foreign invested companies to carry out



discretionary Yuan conversion of their capital fund. Meanwhile, various verbal instructions have been given by SAFE’s local arms to step up controls on foreign currency purchase and capital outflow. Consequently, pressure of capital outflow relieved. As was shown in the chart, the Gap between Bank Receipt & Payment on behalf of Clients reduced from USD72.5 billion in December 2015 to USD8.9 billion in April 2016. The foreign exchange reserve also picked up by a combined USD17.4 billion in March and April 2016.

However, the slight recovery was soon erased, as the foreign exchange reserve fell by USD27.9 billion and the six-month’s continuous narrowing of the Gap between Bank Receipt & Payment on behalf of Clients regained its foot to widen in May. To offset the loss of foreign exchange reserve and battle against resurging risk of capital outflow, SAFE is leveraging the new policy tool of discretionary Yuan conversion under foreign debt account nationwide, after a mere 6-month’s pilot running of the program in the Free Trade Zones<sup>2</sup>.

<sup>1</sup> Prior to the new circular, Yuan conversion of foreign debt fund must be conducted within 5 working days before payment.

<sup>2</sup> Free Trade Zones refers to the Shanghai, Tianjin, Guangdong and Fujian Free Trade Pilot Zones.

## HIGHLIGHTS

The new circular has expanded the fund eligible for discretionary Yuan conversion to foreign debt fund, and clarified the protocols that the companies and their transaction banks shall adhere to at conducting Yuan conversion under a capital account. Especially, by prohibiting the lending of foreign debt to a non-related third party, lending the Yuan-converted borrowed fund on intra-group basis becomes possible<sup>3</sup>. In addition, investment of loan fund, as well as its converted Yuan fund on principal guaranteed wealth management products is permitted<sup>4</sup>.

### **Eligible Fund in Capital Account for Discretionary Yuan Conversion**

Mainland incorporated non-financial companies may request their transaction bank to convert their fund in the following categories at their own discretion when operational needs rise.

- Foreign debts fund<sup>5</sup>
- Capital fund including those in FDI account, domestic asset capitalization account, and domestic reinvestment account
- Fund raised from overseas listing, and
- Fund in other type of eligible capital account

Once Yuan conversion was completed, the fund shall stay in a Yuan account for further payment.

### **Usage of Converted Fund in Yuan Account**

It is important to note that the fund in a capital account and its converted Yuan account is strictly prohibited to be used on the four purposes listed below. While relending to a non-related company is not allowed, it can be interpreted that in contrast, it works when the relending subject is a domestic related party.

- Illegal or non-business related direct and indirect payment
- Security or wealth management investment, except for the principal guaranteed wealth management products
- Relending to non-related companies, except where companies are licensed to carry out such business
- Investment into real estate not for self-use, except for licensed property companies

The new circular has also outlined four categories that the Yuan account may hold:

- The converted Yuan from the above mentioned sources
- Yuan paid back to the account after eligible transaction such as cash deposit as collateral, or cancellation of transaction
- Received interest income, and
- Other income subject to SAFE's advanced approval

On the other hand, the payment from the Yuan account is limited to the following range:

- Justified payment within a company's business scope
- Domestic equity investment and cash deposit as collateral
- Remittance to capital fund centralized management account, or to a similar Yuan account opened under the same company's name.
- Repayment of foreign debt directly or after conversion into foreign currency
- Repurchase of offshore stocks, payment of expenses of offshore listed companies directly or after conversion into foreign currency
- Payment related to China business withdrawal or capital reduction to foreign investors directly or after conversion into foreign currency etc., and
- Others subject to advanced approval by SAFE

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<sup>3</sup> According to the verbal guidance of Shanghai SAFE, relending of the Yuan-converted foreign debt fund to a domestic related company is permitted, but to an offshore related company is prohibited.

<sup>4</sup> Prior to the new circular, foreign currency-denominated foreign debt fund can be used for term deposit of up to 1 year before Yuan conversion being conducted.

<sup>5</sup> Discretionary Yuan conversion of foreign debt fund is expanded nationwide by the new circular.

## COMMENTS

The introduction of discretionary Yuan conversion under capital account is expected to encourage the sale of foreign currency, allowing China to curb the slide of its foreign exchange reserve. It will also enable mainland companies to manage their foreign exchange risk under capital account in a more flexible manner, thus help to improve their fund efficiency. Moreover, by loosening the restriction on intra-group relending of foreign debt, the new circular is likely to inspire new financial services and bring additional business opportunities to Chinese companies.

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