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ECONOMIC REFORM | CHINA | January 2014

PBOC releases new circular on Shanghai FTZ

BACKGROUND

On 2 December 2013, the People's Bank of China ("**PBOC**") issued its opinion (the "**Opinions**") on financial supports for China (Shanghai) Pilot Free Trade Zone ("**Shanghai FTZ**"). While some policies still need further details and implementing rules, the Opinions show the PBOC's great support for the Shanghai FTZ. Most of these new policies should be implemented within the next three months according to PBOC's Shanghai branch.

ANALYSIS

The Opinions mainly cover management of free trade accounts, cross-border investments and transactions, use of cross-border RMB, and interest rate liberation and foreign exchange reforms.

Management of free trade accounts

The Opinions introduce a new type of bank account that can be opened in the Shanghai FTZ by the residents[1] in the FTZ, the free trade account ("**FTA**"). These accounts allow transactions to be made in both local and foreign currency, including for outbound investments and borrowing of foreign loans.

Non-residents may also open free trade accounts for non-residents ("**FTN**") at banks inside the FTZ, which allow both local and foreign currency transactions.

Funds can be freely transferred between FTAs, FTNs, and other offshore accounts and onshore non-resident accounts. FTA holders may also transfer funds in their FTA to their other onshore accounts (or vice versa) based on cross-border transactions, such as current account business, repayment of loans, investments, etc. As we understand, banks will still require their usual documents for cross-border transactions, such as contracts and invoices. Further, even if the Opinions do not set forth any restraints on such fund transfers, future implementing rules may subject them to a quota.

FTZ residents will also be able to use their FTAs for cash pooling among their domestic and foreign subsidiaries/affiliates.

Fund transfers between FTAs and other onshore accounts outside the FTZ not belonging to the same entity will be regulated as cross-border transactions.

[1] "Residents" mean residents of China, including (1) all natural persons who have resided in China for more than one year; and (2) businesses or institutions (including foreign-invested enterprises and financial institutions with foreign capital) with legal person status established within China according to law.

Cross-border investments and transactions

No prior approvals: Under the Opinions, companies in the Shanghai FTZ conducting outbound investment may remit funds overseas without any prior approval from authorities. However, the *General Plan* of the FTZ still requires FTZ companies to file their outbound investments with authorities. Whether banks will require a record of filing to process remittances is subject to further clarification from the banks. In addition, according to some FTZ officials, outbound investments over USD 1 billion must still be approved by the Ministry of Commerce.

Individual investments: Qualified individuals[2] working in the FTZ may invest in foreign securities or conduct other outbound investment. They may also transfer income obtained legally in the FTZ to offshore accounts. However, it is unclear whether such individuals can use only the income they gained in the FTZ for their outbound investments, or whether they may also use their other income gained outside the FTZ.

Qualified foreign workers in the FTZ may invest in the Chinese securities market or conduct other onshore investment, though the PBOC has yet to clarify the eligibility criteria for either foreign workers or individuals.

Capital markets: Financial institutions and companies in the Shanghai FTZ may invest in the Shanghai securities and futures market. Parent companies of the companies in the FTZ may issue RMB-denominated bonds in the onshore market. Qualified companies in the FTZ will be allowed to invest in offshore securities markets, including derivatives, to hedge their risks, though the PBOC has yet to clarify the eligibility criteria for the said qualified companies in the FTZ.

Foreign loans: Companies, non-banking financial institutions and other organisations registered in the FTZ may borrow offshore funds based on their business needs. Such offshore loans will still be subject to foreign loan administration.

Promoting use of cross-border RMB

Financial institutions in Shanghai may handle cross-border RMB transactions related to current accounts and foreign direct investments upon payment instructions from individuals or companies in the FTZ. Documents usually required by banks, such as agreements, customs clearances and invoices, are no longer needed.

Financial institutions in Shanghai may also provide RMB clearing services to cross-border e-commerce transactions in cooperation with a licensed payment institution in the FTZ.

Financial institutions and companies in the FTZ may borrow offshore RMB; however, these funds cannot be invested in securities or derivatives or used for entrusted loans.

Interest rate liberalisation

The Opinions remain very general on interest rate liberalisation, saying that liberalisation will occur when the right time comes. The PBOC will also remove the ceiling rate on small foreign currency deposits at the “appropriate” time. Qualified financial institutions in the FTZ will have priority when to issue large negotiable certificates of deposit.

Foreign exchange reforms

The Opinions extend the scope of pilot multinational companies that may conduct cash pooling in foreign currency. Foreign exchange registration for foreign direct investments is now conducted by banks instead of the State Administration of Foreign

[2] The Opinions do not define “individuals”, though we understand it to mean PRC citizens.

Exchange. The Opinions support the development of the financial leasing industry in the FTZ and will simplify approval procedures for it.

Risk control in the FTZ

All the aforementioned financial reforms are subject to the supervision of anti-money laundering, anti-terrorist financing and regulation of tax evasion. The PBOC will also establish a living monitoring mechanism towards fund flow in the FTZ. The PBOC may, at its discretion, put forth stronger supervision of short-term speculative fund flows in the FTZ, and even take temporary control measure against such fund flow.

COMMENTS

The Opinions detail the financial reforms first presented in the State Council's General Plan released in September 2013. They do not differ much from expectation.

Some provisions in the Opinions, such as operation of FTAs and FTNs and cross-border RMB transactions are ready to be implemented. In fact, many domestic banks are well-prepared to promote their banking services in response to the Opinions.

On the other hand, other policies remain unclear. For example, individual outbound investments still require further detailed implementing rules, while interest rate liberalisation must wait for the "right" time.

Lastly, even though the PBOC has relaxed control on cross-border fund flow, transactions between the FTZ and the rest of China may still be considered cross-border transactions subject to the close monitoring of the PBOC and banks.

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