China's Drive to Open up the NPL Market to Foreign Investors

Bo Yan and Taoye Ye of Haiwen & Partners discuss CBIRC's amended rules governing the regulatory approvals of non-bank financial institutions, which lowers the bar for foreign investment in national asset management companies.

On March 27, 2020, the China Banking and Insurance Regulatory Commission (CBIRC), China's banking and financial institution regulator, issued the *Implementing Measures on Administrative Permission Matters of Non-Bank Financial Institutions* (the 2020 Measures) (非银行金融机构行政许可事项实施办法), which immediately took effect and replaced those promulgated in 2018 (the 2018 Measures).

This regulation change, together with recent developments in the non-performing loans (NPL) sector, signals China's willingness to further open up its NPL market to foreign investors. In particular: (i) entry into the China-U.S. trade deal which permits U.S. financial service providers to apply for provincial asset management company (AMC) licenses; and (ii) endorsement by local governments to set up other forms of NPL investment platforms by foreign investors will be discussed.

Changes under the 2020 Measures

Compared with the 2018 Measures, the 2020 Measures made the following changes regarding foreign investment into asset management companies at the national level (National AMCs):

- foreign investors are no longer required to be a strategic investor in order to invest into a National AMC;
- CBIRC's prior approval will no longer be required so long as the investor holds or acquires, on an accumulative basis, no more than 5% of the shares in a National AMC and does not have significant influence on the operation and management of such a company; and
- shareholders other than major shareholders are no longer subject to a five-year lock-up. A "major shareholder" is defined as a shareholder holding 5% or more of the shares or otherwise having significant influence on the operation and management.

In addition, back in 2018, CBIRC removed the shareholding cap on foreign investment in National AMCs (20% for a single foreign investor and 25% for an entire foreign investment). Hence, in theory, a foreign investor can hold shares of up to 100% in a National AMC.

The 2020 Measures set out the qualification requirements of foreign investors for a National AMC (see the table below for the list of requirements). The way the 2020 Measures are drafted seems to indicate that such qualification requirements only apply to foreign investment into an existing National AMC (as opposed to a greenfield incorporation of a new National AMC by foreign investor(s)). However, based on past experience dealing with other types of financial institutions, it is likely that the regulators will apply the same qualification standards when approving a greenfield incorporation. It should be noted that under the 2020 Measures, qualified foreign investors are limited to foreign incorporated financial institutions.

Qualifications	2018 Measures	2020 Measures	Remarks(s)
Type of investors	Foreign financial institutions	Foreign financial institutions	No change
Total assets	Total assets as at end of the most recent fiscal year must, in principle, be no less than US$10 billion	Total assets as at end of the most recent fiscal year must, in principle, be no less than US$10 billion or in other equivalent freely-convertible	No substantive change

Qualifications	2018 Measures	2020 Measures	Remarks(s)
		currency	
Credit status	Good credit rating by a CBIRC-recognized international rating organization for the most recent two years	Good credit rating for the most recent two years	No substantive change
Sustained profitability	Profitable for the most recent two fiscal years	Good financial status, and profitable for the most recent two fiscal years	No substantive change
Capital adequacy ratio/total capital	If the applicant is a commercial bank, its capital adequacy ratio must be no lower than the average ratio of the banking industry at its domicile and must be no less than 10.5%; if the applicant is a non-banking financial institution, its total capital must be no less than 10% of its total weighted risk assets	If the applicant is a commercial bank, its capital adequacy ratio must be no lower than the average ratio of the banking industry at its domicile and must be no less than 10.5%; if the applicant is a non-banking financial institution, its total capital must be no less than 10% of its total weighted risk assets	No change
Internal Control	Sound and effective internal control	Sound and effective internal control	No change
Requirement on domicile	Proper regulatory system for financial institutions at its domicile	Proper regulatory system for financial institutions at its domicile	No change
Economic condition of the domicile country	Good economic conditions at its domicile country (region)	Good economic conditions at its domicile country (region)	No change
Sources of capital	It must use self-owned funds and must not use non-self-owned funds (such as entrusted funds or debt funds) for capital injection	It must use self-owned funds and must not use non-self-owned funds (such as entrusted funds or debt funds) for capital injection	No change
Lock-up period	All foreign investors must undertake a five-year lock-up period (except for any transfer ordered by CBIRC)	Major shareholders must undertake a five-year lock-up period (except for transfers under any risk disposal measures approved by CBIRC, transfers ordered by CBIRC, mandatory court enforcement or transfers to affiliates)	five-year lock-up period only applies to major shareholder, with more exceptions
Equity investment ratio	N/A	Net equity investment must, in principle, be no more than 50% of its net assets, taking into account the proposed investment in the National AMC	New financial threshold
Other prudent requirements	Other prudent requirements stipulated by CBIRC rules	Other prudent requirements stipulated by CBIRC rules	No change

Legal framework of setting up local AMCs

Pursuant to Article 4.5(2) of the *China-U.S. Phase One Trade Agreement* (the Trade Deal), U.S. financial services providers can apply for AMC licenses in China that would permit them to acquire NPLs directly from Chinese banks beginning with provincial licenses.

However, the 2020 Measures only apply to foreign investment in National AMCs (as opposed to asset management companies at the provincial level (Local AMCs). Furthermore, the current legal framework governing Local AMCs (Local AMC Regulations) does not specifically address the circumstance of investment into, or greenfield incorporation of, Local AMCs by foreign investors. Such Local AMC Regulations primarily include: (i) the *China Banking Regulatory Commission, Circular on Relevant Issues Such as the Criteria for Recognizing the Qualifications of Local Asset Management Companies for Carrying out Batch Purchase and Disposal of Non-Performing Assets of Financial Enterprises* (关于地方资产管理公司开展金融企业不良资产批量收购处置业务资质认可条件等有关问题的通知) (No. 45 [2013] of the China Banking Regulatory Commission) (Circular 45), (ii) the *General Office of the China Banking Regulatory Commission, Letter on Appropriately Adjusting the Relevant Policies for Local Asset Management Companies* (关于适当调整地方资产管理公司有关政策的函) (Letter No. 1738 [2016] of the General Office of the China Banking Regulatory Commission) (Letter 1738), and (iii) the *General Office of the China Banking and Insurance Regulatory Commission, Circular on Strengthening the Regulation of Local Asset Management Companies* (中国银保监会办公厅关于加强地方资产管理公司监督管理工作的通知) (No. 153 [2019] of General Office of the China Banking and Insurance Regulatory Commission) (Circular 153).

It is possible that CBIRC may issue regulations and/or guidelines governing foreign investment in, or greenfield incorporation of, Local AMCs down the road.

Based on the current Local AMC Regulations, the key points are summarized as follows:

- **Approval authority**: The incorporation of a Local AMC must be approved by local government at the provincial level, which will then be filed with the Ministry of Finance and CBIRC. In practice, CBIRC reviews the shareholding structure and the background of the shareholders before officially endorsing the incorporation. Therefore, in essence, CBIRC has certain discretion over the incorporation of Local AMCs. In terms of the incorporation of foreign-invested AMCs, it is still uncertain whether the power of approval would remain with local government or be reclaimed by CBIRC.

- **Territorial restrictions**: Unlike National AMCs, Local AMCs are only allowed to purchase NPLs in bulk from banks and other financial institutions located in the province where such Local AMC are incorporated. Therefore, the location of the Local AMC is critical to its business development. Under the current framework, in principle, each province can only have two Local AMCs. For those provinces in which banks are active in disposing NPLs, the quota of setting up Local AMCs has been used up. As such, foreign investors should carefully consider the location of the incorporation by taking into consideration of both the supplies of NPLs in such a province and the market competition.

- **Incorporation requirements**: The minimum registered capital for incorporating a Local AMC is Rmb1 billion, and such registered capital must, in principle, be contributed before the Local AMC commences operation. The capitalization requirement is more rigorous compared to that for setting up other types of NPL investment platforms (e.g. a Super WFOE or an FLP as set out below) and may cause serious capital/cash trap issues for investors, whereas foreign investors of non-licensed NPL platforms have more flexibility when injecting capital in line with the investment timetable.

- **Qualifications of foreign investors:** In determining the foreign investor qualifications for setting up Local AMCs, reference may be made to the qualification requirements under the 2020 Measures. Considering that Local AMCs do not constitute financial institutions in nature, the qualification thresholds for foreign investors in Local AMCs will likely be lower compared to those in National AMCs.

- **Possibility for non-U.S. investors:** Although the preferential treatment under the Trade Deal only applies to U.S. financial services providers, there is a chance that such treatment may also be extended to non-U.S. investors. There has been speculation in the market that CBIRC is likely to grant the same treatment to all foreign investors on a non-discriminatory basis when promulgating implementation rules.

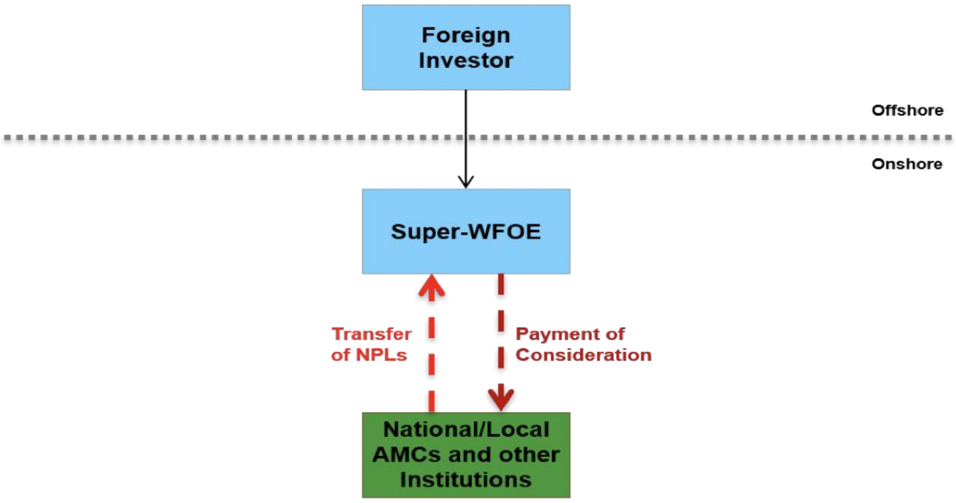
- **Compliance regime:** There are no unified rules governing the operation and compliance of Local AMCs. Such compliance and risk control measures are primarily promulgated by provincial governments, which may include capital adequacy ratios and liquidity requirements, and thus vary from locality to locality.

Other options for establishing NPL investment platforms

In addition to National AMCs and Local AMCs, there are two alternative structuring options for foreign investors to set up their NPL investment platforms in China.

(1) Establishing a Super WFOE

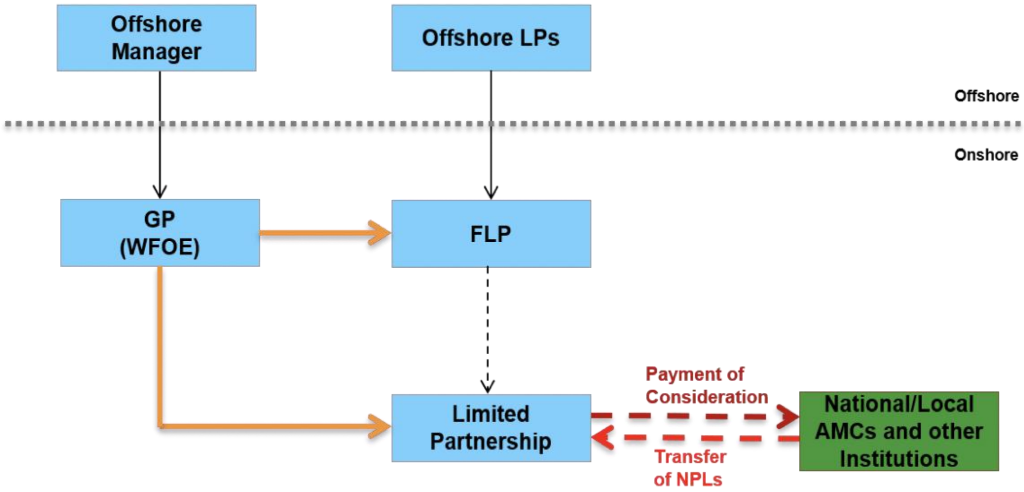
Foreign investors may establish a wholly foreign-owned company in China that can purchase NPLs from National AMCs, Local AMCs and other institutions (subject to the breadth of its approved business scope) (the Super WFOE). It should be noted that a Super WFOE cannot acquire NPLs in bulk from banks and other financial institutions. The shareholding structure of a Super WFOE is as follows:



There are no clear rules or guidelines regulating the establishment of a Super WFOE (e.g. qualification requirements of foreign investors, registered capital or other incorporation requirements). The application for such Super WFOEs must be reviewed and approved by the local government on a case-by-case basis. At least five Super WFOEs have been approved and incorporated.

(2) Establishing an FLP

Foreign investors may also elect to establish a foreign-invested limited partnership in China (FLP) and additional limited partnership(s) underneath the FLP, for the purpose of purchasing NPLs from National AMCs, Local AMCs and other institutions. The shareholding structure of such an option is generally as follows (subject to adjustment based on local regulatory requirements):



Similarly, there are no clear rules or guidelines regulating the establishment of such structure. The application must be reviewed and approved on a case-by-case basis. However, some local governments have supported the establishment of such a structure.

Conclusion

The NPLs from commercial banks have exceeded Rmb2.4 trillion as of 31 December 2019 according to statistics released by CBIRC, and is expected to further increase as a result of the recent Covid-19 pandemic. It has become an urgent task for the government to accelerate NPLs disposal and expand the disposal channels for preventing and mitigating financial risks. Against such background, Jiantou Zhongxin Asset Management Co., Ltd. has been approved to be converted into a National AMC, breaking the 21-year drought, and many local governments are aiming to set up new Local AMCs.

Foreign investors have also shown growing interest in China's NPL market and are exploring to set up onshore investment platforms to enhance their access to the NPL opportunities. It is expected that the 2020 Measures and the potential new rules governing foreign investment in Local AMCs will bring new opportunities to foreign investors.