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CBRC Financial Leasing: Is the Door still Open to Foreign Investors?

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This legal commentary (this "**Legal Commentary**") aims to provide foreign investors interested in establishing and operating financial leasing companies ("**CBRC FLCs**" or "金融租赁公司") regulated by the China Banking Regulatory Commission (the "**CBRC**") in the People's Republic of China (the "**PRC**", for the purpose of this Memo, the "PRC" excludes Hong Kong, Macau and Taiwan) with a general introduction of the applicable legal regime and current approval practices of the CBRC.

1. Overview of the Legal Regime Applicable to CBRC FLCs

The establishment and operation of CBRC FLCs are mainly governed by the following PRC regulations:

- the *Measures for the Administration of Financial Leasing Companies* ("**Measure 1**") promulgated by the CBRC on January 23, 2007; and
- the *Implementation Rules for Administrative Approvals for Non-Banking Financial Institutions* ("**Rule 13**") promulgated by the CBRC on August 3, 2007.

Pursuant to Measure 1, CBRC FLCs are non-bank financial institutions approved by the CBRC that engage primarily in the business of Financial Lease (as defined below). "**Financial Lease**" ("融资租赁") refer to transactions whereby the lessor, based on the lessee's selection or confirmation of the supplier(s) and the leased goods, purchases the leased goods from the supplier(s) and leases the same to the lessee. The lessee will occupy and use the leased goods in accordance with the leasing contract and pays rent to the lessor. According to Measure 1, properties suitable for Financial Lease shall be fixed assets.

Your attention is drawn to the difference between the CBRC FLCs established under Measure 1 and the foreign-invested financial leasing companies ("**MOFCOM FLCs**" or "外商投资融资租赁公司") established under the *Management Measures on Foreign Investments in the Leasing*

Industry ("**Notice 5**") promulgated by the Ministry of Commerce ("**MOFCOM**") on February 3, 2005. CBRC FLCs are financial institutions that will be issued a financial license (the "**Financial License**", "金融许可证") after its commencement of business, whereas MOFCOM FLCs are not financial institutions and could not obtain a Financial License. Indeed, CBRC FLCs and MOFCOM FLCs are subject to different sets of regulatory regimes and are administered by different government bodies, i.e., CBRC and MOFCOM, respectively. As compared to MOFCOM FLCs, CBRC FLCs are more heavily regulated and supervised. On the other hand, CBRC FLCs also enjoy certain advantages, such as a wider permitted business scope (please refer to Section 4 below). As of the end of 2012, a total of 20 CBRC FLCs have been approved by the CBRC.

2. Foreign Investment in CBRC FLCs

Foreign investments in CBRC FLCs used to be a restricted sector under the 2007 version of the *Foreign Investment Industries Guidance Catalogue* (the "**Catalogue**"). The new Catalogue, which was issued by the National Development and Reform Commission ("**NDRC**") and the MOFCOM on December 24, 2011 and effective as of January 30, 2012, reclassifies foreign investment in CBRC FLCs from the "restricted" category into the "permitted" one. Thus, foreign investments in CBRC FLCs are now classified as a permitted sector under the new Catalogue. It is still unclear whether this important change will have a positive impact on CBRC's attitude towards foreign investments in CBRC FLCs. Nevertheless, foreign investment in CBRC FLCs is still subject to strict restriction in practice.

The *Measures for the Administration of Equity Investment by Overseas Financial Institutions in Chinese-invested Financial Institutions* ("**Circular 6**") promulgated by the CBRC on December 5, 2003 provides the following restrictions on foreign investments in Chinese financial institutions, (i) a single foreign investor may not hold more than 20% of the equity interest in a Chinese-invested financial institution; and (ii) where the aggregate equity interests held by foreign investors is 25% or more, a non-listed financial institution will be regulated as a foreign-invested financial institution.

Although Measure 1 actually allows foreign investors to act as a principle investor in a CBRC FLC by specifying the relevant qualification requirements (see Section 3.1(a) below), in practice, the CBRC is extremely conservative with respect to foreign investment in CBRC FLCs. Presently, there are very few, if any, CBRC FLCs with foreign investments. In addition, the CBRC, based on Circular 6, has never approved any CBRC FLCs with an aggregate foreign investment of 25% or more. The first CBRC FLC with foreign investment, CCB Financial Leasing Corporation Limited ("**CCB Leasing**", Han Kun attorneys represented Bank of America in its equity investment into CCB Leasing), has just announced the transfer of the 24.9% equity interest previously held by Bank of America to its Chinese shareholder, China Construction Bank, making CCB Leasing a fully owned subsidiary of China Construction Bank.

Furthermore, please note that commencing from the second half of 2012, the CBRC has effectively suspended its approval for the establishment of any new CBRC FLCs, whether foreign invested or not. As such, it is very difficult in practice at this time to establish a CBRC FLC with foreign investment. We will watch closely CBRC's practice in approving foreign-invested CBRC FLCs and keep you updated .

3. Conditions for Establishing CBRC FLCs

3.1 Qualification Requirements for Investors

Pursuant to Measure 1, the investors of a CBRC FLC should consist of one principal investor and several general investors. The principal investor should contribute more than 50% of the registered capital of a CBRC FLC, while all other investors of a CBRC FLC are classified as general investors.

(a) Qualification Requirements for the Principal Investors

Pursuant to Article 9 of Measure 1, the principal investor of a CBRC FLC can be a commercial bank, whether registered domestically or overseas; a leasing company, whether registered domestically or overseas; a domestically registered large-scale enterprise that mainly engages in the manufacturing of products suitable for financial leasing and other financial institutions approved by the CBRC. The qualification requirements for the different categories of principal investors are set out below:

(i) Domestically and Overseas Registered Commercial Banks:

- Capital adequacy ratio: The capital adequacy ratio of the bank should conform to the local regulatory requirements at the place where the bank is registered and should in no event be less than 8%;
- Total assets: The total assets of the bank at the end of the immediately preceding year should be no less than RMB 80 billion or an equivalent amount in a freely convertible foreign currency;
- Continued profitability: The bank should have been profitable for the last two consecutive years;
- Legal compliance: The bank should comply with the local laws and regulations at its place of registration and should not have been involved in any major cases or committed any serious violations of the laws or regulations during the immediately preceding two years;
- Sound corporate governance: The bank should have a well-established corporate governance structure, internal control system and sound risk management system;
- Requirements for foreign commercial banks: The jurisdiction where such

bank is incorporated should have sophisticated financial supervisory and regulatory legal regime, and should be in good economic conditions; and

- Other conditions of prudence: The bank should meet other conditions of prudence specified by the CBRC.

(ii) Domestically and Overseas Registered Leasing Companies:

- Total assets: The total assets of the leasing company at the end of the immediately preceding year should be no less than RMB 10 billion or an equivalent amount in a freely convertible foreign currency;
- Continued profitability: The leasing company should be profitable for the last two consecutive years;
- Legal compliance: The leasing company should comply with the local laws and regulations at its place of registration and should not have been involved in any major cases or committed any serious violations of the laws or regulations during the immediately preceding two years;
- Requirements for foreign leasing companies: The jurisdiction where such leasing company is incorporated should be in good economic conditions; and
- Other conditions of prudence: The leasing company should meet other conditions of prudence specified by the CBRC.

(iii) Chinese Large-scale Manufacturing Enterprises:

- Sales revenue: The sales revenue of the enterprise for the immediately preceding year should be no less than RMB 5 billion or an equivalent amount in a freely convertible foreign currency;
- Continued profitability: The enterprise should be profitable for the last two consecutive years;
- Net asset: The ratio of net assets of the enterprise at the end of the immediately preceding year should be no less than 30% (on a consolidated basis);
- Sales revenue of principal business: The sales revenue of the enterprise from its principal business should account for more than 80% of the total sales revenue;
- Good credit records: The enterprise should have good credit records;
- Legal compliance: The enterprise should comply with the PRC laws and regulations and should not have been involved in any major cases or committed any serious violations of the laws or regulations during the immediately preceding two years; and

- Other conditions of prudence: The enterprise should meet other conditions of prudence specified by the CBRC.

(b) Qualification Requirements for the General Investors

Any person fulfilling the qualification requirements for principal investors can also serve as a general investor in CBRC FLCs. In addition, other domestic and foreign financial institutions (not limited to banks or leasing companies) as well as domestic non-financial institutions (not limited to large-scale manufacturing enterprises) may also act as general investors for CBRC FLCs, provided that they satisfy a less stringent qualification requirement. In particular, foreign investors acting as a general investor must be a financial institution, and should meet the following conditions:

- Total assets: The total assets at the end of the immediately preceding year should in principle be no less than RMB 1 billion;
- Continued profitability: The financial institution should have been profitable for the last two consecutive years;
- Capital adequacy ratio: If the financial institution is a commercial bank, the capital adequacy ratio of the bank should not be less than 8%; for other financial institutions, they must conform to the local prudential regulatory requirements at its jurisdiction of registration;
- Internal control system: The financial institution should have sound and effective internal control system;
- Sophisticated local regulatory regime: The jurisdiction where such financial institution is registered should have sophisticated financial supervisory and regulatory legal regime;
- Good economic condition: The jurisdiction where such leasing company is incorporated should be in good economic conditions; and
- Other conditions of prudence: The financial institution should meet other conditions of prudence specified by the CBRC.

In addition, the general investors should undertake not to (i) transfer the equity interest held in CBRC FLCs (except as ordered by the CBRC); (ii) pledge such equity interest; or (iii) establish a trust on such equity interest, in each case within three years. Such undertakings of the general investors should be explicitly stated in the articles of association of the CBRC FLCs.

3.2 Other Establishment Conditions

(a) Registered Capital

The minimum amount of registered capital of a CBRC FLC is RMB 100 million (or the equivalent amount of a freely convertible foreign currency). The registered capital of a CBRC FLC should have been fully paid-in.

(b) Corporate Governance and Place of Business

The proposed CBRC FLC must have its articles of association in compliance with the *PRC Company Law* and Measure 1. Further, the proposed CBRC FLC should also have sound corporate governance, internal control, business operation and risk prevention systems. The proposed CBRC FLC must operate in a proper business premise with safety measures and other business related facilities installed.

(c) Proper Personnel

The directors and senior management of the proposed CBRC FLC should be subject to the approval by the CBRC as regards their qualification to take up such positions. The proposed CBRC FLC should also be staffed with qualified personnel familiar with the financial leasing business.

3.3 Establishment Procedure for CBRC FLCs

Pursuant to Article 12 of Measure 1, the establishment of a CBRC FLC shall go through the preparation stage ("筹建") and the commencement of business stage ("开业").

4. Permitted Business Scope of CBRC FLCs

Unlike MOFCOM FLCs, a CBRC FLC may, in addition to engaging in the financial leasing activities, carry out the following businesses upon approval by the CBRC:

- Accepting one-year or longer fixed-term deposits from the shareholders;
- Accepting security deposit from lessees;
- Assignment of leasing receivable to commercial banks;
- Issuance of financial bonds upon approval;
- Interbank lending and borrowing;
- Borrowing from financial institutions;
- Foreign exchange borrowing from overseas;
- Remarketing and disposition of residual value of the leased goods;
- Economic consultancy; and/or
- Other businesses as approved by the CBRC.

However, pursuant to Article 23 of Measure 1, CBRC FLCs may not take deposits from its shareholders that are banks.

5. Financial Lease of Special Assets

As CBRC FLCs are permitted to be engaged in the Financial Lease of fixed assets, they are in principle eligible to carry out financial leasing businesses in respect of ships and aircrafts. In practice, many CBRC FLCs conduct such leasing activities through project companies established in free trade zones, in which case additional approvals should be obtained. Please note that the legal regimes with respect to the leasing of ships and aircrafts are very complicated. A legal analysis will highly depend on the structure of each deal, and additional governmental approvals may also be involved. Therefore, a case-by-case analysis would be recommended in relation to the leasing of ships and aircrafts.

As for medical devices, pursuant to the *Reply on the Regulation of Financial Lease of Medical Devices* issued by the State Food and Drug Administration of the PRC ("**SFDA**") on June 1, 2005, and Article 24 of the *Regulations on Supervision and Administration of Medical Devices* promulgated by the State Council of the PRC on January 4, 2000, CBRC FLCs that wish to carry out the Financial Lease of medical devices should first either make a filing to the drug supervision and administration department at the provincial level or obtain a Medical Device Operating Enterprise Permit from the SFDA.

6. Operation of Financial Leasing Companies

6.1 Material Compliance Issues

Pursuant to Chapter 5 (*Supervision and Administration*) of Measure 1, a CBRC FLC should at all times comply with the following regulatory requirements:

(a) Capital adequacy ratio. The amount of net capital of a CBRC FLC should not be lower than 8% of the risk-weighted assets;

(b) Financial concentration to a single customer. The balance of financing (after deducting the amount of security deposit) to a single lessee should not exceed 30% of the CBRC FLC's net capital;

(c) Degree of affiliation with a single customer. The balance of financing to an affiliated party of the CBRC FLC should not exceed 30% of its net capital;

(d) Degree of affiliation with customers of the same group. The balance of financing to all affiliated parties of the CBRC FLC should not exceed 50% of its net capital; and

(e) Inter-bank borrowing ratio. The balance of inter-bank borrowing of CBRC FLCs should not exceed 100% of its net capital.

The CBRC may make appropriate adjustments to the restrictions above from time to time in light of the actual needs of its regulatory works.

6.2 Material Changes

Pursuant to Article 17 of Measure 1, the following changes to a CBRC FLC shall require prior approval from the CBRC:

(a) Name change;

(b) Change of organization type;

(c) Adjustment to business scope;

(d) Change in registered capital;

(e) Change in equity;

(f) Amendment to its articles of association;

(g) Change in registered place or business premises;

(h) Change in directors and senior executives;

(i) Merger and division; or

(j) Other changes as specified by the CBRC.

6.3 Establishment of Branch Offices

Pursuant to Article 15 of Measure 1, the establishment of any branch office by a CBRC FLC shall be subject to the prior approval by the CBRC.

6.4 Reporting Requirements

Pursuant to Articles 39 to 41 of Measure 1, CBRC FLCs shall comply with the following requirements:

(a) <u>Financial statements</u>: CBRC FLCs should prepare and submit to the CBRC its balance sheet, profit and loss statement, and other financial statements as required by the CBRC. The legal representative and directly responsible persons of the CBRC FLC shall assume legal liabilities for the authenticity of the statements submitted;

(b) <u>Affiliated transactions</u>: CBRC FLCs should submit to the CBRC or its regional offices a report on affiliated transactions of the immediately preceding accounting year within four months after the end of each accounting year. The report should include, among other things, the affiliated parties, types of transactions, amount and subject matters of the transactions, the transaction price and pricing method, profit or loss of the transactions, nature and proportion of the affiliated party's rights and interests in the transactions; and

（c） <u>Audit report</u>: CBRC FLCs should develop a system for regular external audits and submit the annual audit report signed by its legal representative within four months after the end of each accounting year to the CBRC and its regional offices.

Important Announcement

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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