Evolving Standards and Practices in China’s Banking Industry

New Rules Impacting the Structuring and Trading of Real Estate Loans
China’s banking regulators are in the news. Their next moves in hiking interest rates or increasing bank reserve ratios are subjects of lively debate in both the international and domestic media as market observers speculate on China’s strategies to contain aggressive lending and cool inflation. China’s banking regulators, in fact, are quite active and frequently issue new regulations which are not covered in the general press. For example, two new regulations promulgated by China Banking Regulatory Commission (“CBRC”) at the end of last year have not gotten much attention, but they do have important impacts on the way loans in China are both structured and traded. The regulations are:

- Notice Regarding Regulation of Loan Repayment Method for Mid-to-Long Term Loans, issued by the CBRC on December 6, 2010 (Yin Jian Fa [2010] No. 103) (“Notice 103”); and
- Notice on Further Regulating the Credit Asset Transfer Business of Banking Financial Institutions, issued by the CBRC on December 3, 2010 (Yin Jian Fa [2010] No. 102) (“Notice 102”).

In this briefing some of the key features of Notice 103 and Notice 102 are assessed and recommendations are provided for dealing with the changes these Notices introduce to finance standards and practices.

UNDERSTANDING NOTICE 103 – IMPACTING ON HOW LOANS ARE REPAID

The repayment of real estate loans can be structured in a variety of ways. For example, some loans may be interest only loans where no principal repayments are due during the term of the loan. Instead the entire principal amount of the loan is repaid in a single payment at maturity. Other loans incorporate an amortization feature, where periodic repayments of principal are required during the term of the loan with the remainder of the principal balance due at maturity. Market players on the lender and borrower side typically view the issue of whether a loan should be an interest only loan or an amortizing loan as a purely commercial point to be negotiated by the parties depending upon the specifics of the deal and the underlying property. In Notice 103, however, China’s regulators have now taken a firm position against interest only loans.

Interest Only Loans Restricted

In effort to minimize credit underwriting risks, Notice 103 now requires all mid term loans (loans with a term of more than one (1) year but not exceeding five (5) years) and long term loans (loans with a term exceeding five (5) years) to incorporate scheduled principal repayments. Interest only loans with a lump sum or bullet principal repayments at maturity are no longer permitted. Notice 103 specifies that installments of principal and interest should be made on a semi-annual basis, although payments on...
a quarterly basis are encouraged where practicable. The Notice does not specify the amount or percentage of principal repayments required on each payment date. Fortunately, the CBRC took a pragmatic approach on this issue and left the determination of the specific amount or percentage of principal repayment on each repayment date to the lender in conjunction with negotiations with the borrower taking into consideration the anticipated cash flows and revenues generated by the underlying project.

In the context of construction loans, where no cash flow is generated during the construction period, there may be a grace period where no principal payments are required. If, however, the loan facility continues past the date construction is completed, scheduled principal repayments on at least a semi-annual basis must commence following the completion of construction.

**Retroactive Application of Notice**

Notice 103 not only applies to all new mid term loans and long term loans going forward but it also applies to existing mid term loans and long term loans. The regulation provides that with respect to such outstanding interest only payment loans, lenders and borrowers should negotiate and amend the loan documents to incorporate scheduled principal repayments on at least a semi-annual, or if possible, quarterly basis. This retroactive application of Notice 103 to existing loans is perhaps the most controversial aspect of the new regulation. It is not entirely clear how this requirement will be enforced in practice particularly where there is no incentive or obligation for a borrower to renegotiate a loan transaction already underwritten and already in effect.

**UNDERSTANDING NOTICE 102 – IMPACTING ON HOW LOANS ARE TRANSFERRED**

The secondary trading of loans has become an important feature of the real estate finance industry in a number of markets. The active syndication and trading of loans, including real estate and other fixed asset loans, in mainland China, however, is still only a developing but growing feature of the market. Circular 102 is the CBRC’s most comprehensive guidance to date governing how financial institutions may transfer loan assets. Note, Circular 102 does not apply to loans which are classified as non-performing loans.

**Borrower and Guarantor Consent to Loan Transfers**

Notice 102, among other things, impacts a key issue of negotiation between lenders and borrowers in some loan transactions; the issue of the consents required for transfers of loans. From the lender’s perspective, the loan should be freely assignable to new lenders. A borrower’s or guarantor’s consent should not be required as a pre-condition to the effectiveness of transfer. On the other hand, some borrowers and guarantors take the view that their consent or at least consultation should be required as they want to have some say as to who they will be dealing with in relation to the loan.

In an effort to make the loan transfer process transparent to the underlying borrower and any guarantor, Notice 102 now restricts loan transfers without certain prior consents. Under Notice 102 the transferor of the loan asset must obtain the consent of the borrower and the guarantor before transferring the loan asset. There is, however, an exception to the borrower’s consent requirement. Borrower consent is not required if the previously executed loan agreement specifies that the borrower’s further
consent to the transfer is not required. Therefore, as long as the loan agreement provides that the borrower effectively waives its right to consent to subsequent loan transfers it would not be necessary to obtain borrower consent for each such subsequent loan transfer.

The ability to waive the guarantor’s consent right, however, is not as clear. Under Notice 102 if a loan is guaranteed, the transferor should consult with the guarantor and obtain the guarantor’s consent before the loan is transferred. If the guarantor does not consent, the transferor should negotiate with the borrower to replace the guarantor or to provide other additional security, so that the loan continues to be comparably secured. The Notice makes no reference to an exception whereby a guarantor, unlike a borrower, may waive in advance its right to further consent of loan transfers. It is not clear if this is intended feature of the regulation or a drafting oversight of the regulators. Logically, there is no reason why the borrower should be able to waive consent rights in advance but a guarantor could not.

**Mechanics of Loan Transfer**

In addition to addressing consent rights, Notice 102 also contains a number of provisions focused on the mechanics of implementing a loan transfer. For example, if a loan is transferred, the new lender must execute documentation with the borrower confirming the transfer of the loan and the establishment of the credit relationship between the borrower and the new lender. In addition, if the loan is secured by mortgaged or pledged property, all appropriate filing and registration procedures must be completed to reflect the identity of the new secured party in all applicable registrations and filings.

It is important to note that these procedures require the cooperation of the borrower. Consequently, if the borrower is opposed to the transfer, it may be reluctant to cooperate in the transfer procedures and thereby slow down or impede the transfer process notwithstanding its prior agreement to waive consent rights in the loan agreement.

**Added Complications for Syndicated Loans**

Increasingly loans, particularly larger loans are being syndicated. If a loan has been syndicated, Notice 102 imposes additional requirements for loan transfers beyond the borrower and guarantor consent requirements. Under the regulation, members of a syndicate have a pre-emptive right to purchase any loan interest which is the subject of a proposed transfer. In other words, the transfer of an interest in a syndicated loan must first be offered to all the existing members of the syndicate each of whom must elect not to acquire the interest before the loan interest may be transferred to a new third party who will then become a new member of the syndicate. This pre-emptive right is not consistent with the existing Guidelines for the Syndicated Loan Business (Yin Jian Fa [2007] No. 68) (the “Syndication Guidelines”) issued by the CBRC in 2007. Under the Syndication Guidelines, when a member of a syndicate desires to transfer its interest in the loan, it only needs to notify the agent bank and the borrower in advance. The Syndication Guidelines do not require the transferor to notify any other syndicate members (other than the agent bank) nor do they grant the other syndicate members any pre-emptive rights.

It is not entirely clear how Notice 102 is intended to be reconciled with the conflicting provisions in the Syndication Guidelines. In addition, Notice 102 is silent on the mechanisms and procedures for the exercise of the pre-emptive right granted to syndicate members in connection with loan transfers.
THE BOTTOM LINE AND RECOMMENDATIONS

The standards and practices in China's banking and finance community are constantly evolving. CBRC Notice 103 and Notice 102 introduce important changes to these standards and practices.

Key recommendations and strategies for market players on both the lender and borrower side, where applicable, in understanding and addressing these changes include the following:

• **Loan Amortization Required:**

  Lenders and borrowers modeling cash flows and repayment requirements for new onshore debt in China will now need to provide for, at the minimum, a semi-annual repayment schedule that includes a principal repayment component. Interest-only loans may no longer be available for most mid term and long term real estate loans. Note, these restrictions only apply to onshore loans issued in China. The restrictions do not apply to offshore loans made, for example, by offshore banks to the offshore holding companies of China real estate projects.

• **Retroactive Compliance with Notice 103 Unclear:**

  Lenders and borrowers may need to address the retroactive application of Notice 103 to old existing loans requiring the introduction of periodic principal repayment features to existing interest only loans. As the procedures and requirements for the retroactive application and enforcement of Notice 103 are not clear, financial institutions in the market have and will continue to adopt differing approaches towards compliance unless and until there is further clear directive from the CBRC.

• **Loan Documents Need to Expressly Address Consent Rights to Preserve Commercial Deal of Parties:**

  Lenders, borrowers and guarantors can still negotiate over assignment consent rights. Nevertheless, careful document drafting will be required to ensure the commercial deal amongst the parties is ultimately preserved. Thus, if the commercial deal is no borrower or guarantor consent required, then loan documents should incorporate express waivers of consent rights to the fullest extent permitted by law as well as express undertakings by the borrower and guarantor to cooperate in the transfer process including cooperating in all mechanical procedures for transfer required pursuant to Notice 102.

• **Members of Loan Syndicate Should Determine Upfront if Pre-Emptive Rights to Loan Transfers are Available:**

  If members of the syndicate determine that there is no interest in pre-emptive rights in connection with loan transfers made by other members of the syndicate, the pre-emptive right should be expressly waived upfront in the applicable finance documents. If pre-emptive rights are desired, then the finance documents need to specify the mechanics and procedures for the exercise of the preemptive right as the regulations do not provide any specific recommended or required mechanics and procedures.

Regulations like those introduced by Notice 103 and Notice 102 may not have far reaching implications on the Chinese economy like reserve ratios and interest rate hikes, but they certainly do have practical implications to real estate lenders and borrowers in documenting, executing and managing loan transactions.
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