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# New Guidelines regarding Mergers and Acquisition Loans of Commercial Banks

## Introduction

The China Banking Regulatory Commission (CBRC) issued a Notice on 6 December 2008 setting out the new “Guidelines on the Risk Management of M&A Loans of Commercial Banks” (No.84 [2008] of the CBRC)(the “Guidelines”). The guidelines overturn a long-standing restriction on the granting of bank loans for equity investments in China and aims to expand the financing channels available to Chinese enterprises. They are expected to boost both onshore and outbound M&A activity.

The Guidelines permit commercial banks incorporated in the People’s Republic of China (PRC) to grant loans to domestic companies to acquire both the equity in, and the assets of, a target company. The Guidelines are effective upon the date of issuance.

The Guidelines are divided into four chapters, namely:

1. Chapter I: General Provisions
2. Chapter II: Risk Assessment
3. Chapter III: Risk Management
4. Chapter IV: Supplementary Provisions

The purpose of this note is to provide a summary of the new Guidelines.

## Chapter I: General Provisions

The purpose of the Guidelines is to regulate the method of how PRC commercial banks grant M&A loans whilst improving their risk management capacity, enhance fair competition and improve competitiveness in the banking sector, as well as safeguard its legal and stable operations.

Definitions of "commercial banks", "M&A" and "M&A loan" are provided for the purposes of the Guide.

Commercial banks shall set up corresponding M&A loan management rules and a management information system as M&A loans require more stringent administration than other loans. It is to ensure that is it able to effectively identify, measure, monitor and control M&A loan risks through the operation flow, the internal control rules and the management information system.

## Chapter II: Risk Assessment

In determining whether or not to grant an acquisition loan, banks, or their external professional advisors are required to evaluate risk factors and use financial models to estimate future cash flows. The Guidelines sets out various methods which both parties to the M&A loan should take into consideration when assessing the risks involved, including but not limited to factors such as: analyzing strategic risks, legal and regulation-compliance risks, integration risks, operating risks, financial risks and other M&A-related risks.

It is advised that the commercial bank should adopt the suggested measures provided in the Guidelines to comprehensively assess the impacts and risks of an M&A loan. This includes setting up a prudent financial model to estimate the future financial data of both parties and analyzing the key financial leverages and indicators to determine the borrower's ability to repay the debt.

**Range of application**

The Guidelines encourage loans to be granted to domestic companies to acquire both the equity in, and the assets of, a target company. Therefore, it is applicable to the acquisition of listed companies. However, banks should not provide loans for the purpose of purchasing stock on the secondary market.

The Guidelines also apply to the acquisitions of an established target enterprise of continuous operation by way of buying the current equity of the target enterprise, subscribing to its new equity, taking over its assets or succeeding to its debts, etc. An M&A transaction can be conducted by the purchaser through a specially established subsidiary company which is wholly owned or controlled by the purchaser and has no other business. This means an alternative choice for enterprises proposing to carry out an M&A transaction.

In terms of onshore acquisitions, Foreign Invested Enterprises ("FIEs") will now have access to alternative sources of funding for both equity and asset acquisitions

The ability of domestic companies to fund outbound acquisitions will also be enhanced. The Guidelines provide private domestic companies (as well as State Owned Enterprises ("SOEs")) an alternative source of funding to support offshore acquisition activities.

**Lender Qualifications**

* Acquisition loans may only be granted by PRC established commercial banks under the PRC Commercial Banks Law which includes domestic commercial banks, local subsidiaries of foreign banks and Joint Venture commercial banks.
* PRC branches of foreign banks are restricted from granting acquisition loans.

**Borrower Qualifications**

* Acquisition financing can only be undertaken by "domestic enterprises".
* FIEs are eligible as "domestic enterprises" so long as their proposed transactions can pass the qualified lenders' risk assessment process.
* It has yet to be determined as to the extent of how other foreign "domestic enterprises" (such as foreign invested holding companies and private equity funds established onshore in China) could, in practice, benefit from the Guidelines.

## Chapter III: Risk Management

**Details of the loans**

To ensure risk management, the commercial bank must make certain that:

* the balance of granted M&A loans does not represent more than 50% of the core net capital of the bank over the same period of time;
* the M&A loan shall account for not more than 50% of the source of funds for the M&A transaction; and
* the term of an M&A loan is generally not more than five years.

Adequate guarantee from an M&A loan borrower should be provided to a commercial bank which can cover the M&A loan risks. The forms of such guarantee include but are not limited to the mortgage of assets, the pledge of stock rights, the warranty provided by a third party and any other forms permitted by law.

In principle, the guarantee requirements for M&A loans shall be higher than other loans. It should be noted that the target enterprise's stock rights could be pledged for the guarantee purpose. And where the target enterprise's stock rights are pledged for guarantee, the commercial bank shall assess the value of such stock rights and determine the pledge rate with more prudent methods.

**Requirements for the transaction**

1. The purchaser in the M&A transaction must have a good regulation-compliance record and a good credit status, and has no record of credit default or evading bank debts;
2. The lenders must consider the "industry relevance", "strategic relevance" and any potential synergy which may emerge between the acquirer and the target;
3. The M&A transaction is legal and, for any matter concerning the state industrial policies, industrial access, anti-monopoly or the transfer of state-owned assets, has obtained the required approval and handled the relevant formalities according to the applicable laws, regulations and policies; and
4. The purchaser and the target enterprise have a relatively high industrial or strategic correlation, and, through the M&A, the purchaser can acquire the strategic resources of the target enterprise such as its R&D capability, key technology, trademark, franchise and supply or distribution network to improve the purchaser's core competitiveness.

**The security measures adopted by banks**

Borrowing from banks may mean a less self-determinative way of carrying out an M&A transaction as the banks may interfere with the limits set thereto. Furthermore, banks may supervise and intervene throughout the entire borrowing period.

In the M&A loan contract, a commercial bank shall stipulate the key clauses to protect the interests of the lender, which shall include but are not limited to:

1. the mandatory clauses on the important financial indicators of the borrower or the enterprise formed after M&A;
2. the mandatory clauses on the borrower's advance repayment made with the extra cash flow acquired under special circumstances;
3. clauses about monitoring the principal or special-purpose account of the borrower or the enterprise formed after M&A; and
4. clauses about the borrower's promise that the lender has the right to know or approve the key issues.

During the M&A process, if the parties to the M&A encounter the following circumstances, both parties to the M&A may take risk control measures:

1. any change in the key shareholders;
2. any change in the key investment projects;
3. any abnormal change in the operation cost;
4. any big adverse change in the brand, clients or market channels;
5. the occurrence of any new, big debt or external guarantee;
6. the sale of key assets;
7. any big change in the dividend strategy; or
8. any other big event that affects the sustainable operation of enterprise.

The following should also be stipulated in the M&A loan contract by a commercial bank:

1. conditions for withdrawing money and the clauses for the granting and use of the loan. The conditions for withdrawing money should at least include that the purchaser shall have sufficient self-raised funds available and the regulation-compliance requirements have been satisfied;
2. the loan contract should stipulate that the borrower has the obligation to, during the period of continued existence of the loan, regularly file the financial statements of both parties to the M&A transaction and the guarantor and other materials as the lender requires; and
3. during the continued existence of the M&A loan, the commercial bank should regularly evaluate the predictability and stability of the future cash flow of both parties and regularly check whether the borrower's repayment schedule matches its source of funds for repayment.

In addition to providing guidance for existing M&A loans, the guidelines also provides the reporting, checking and evaluating mechanisms a commercial bank should effect for non-performing M&A loans.

## Chapter IV: Supplementary Provisions

The power to interpret the Guidelines shall remain with the China Banking Regulatory Commission.

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