

# Client Alert

September 17, 2015

## Circular 122 – China Starts to Unwind Limits on Foreign Investment in Real Estate in Response to Slowing Economy

By Marcia Ellis, Paul McKenzie, Gregory Tan, Maria Wang, and Catherine Rong

Nine years ago, in July 2006, six different Chinese government agencies issued Opinion 171, the first of a number of circulars imposing limits on foreign investment in the property market in response to concerns about a rapidly overheating market. On August 19, 2015, reflecting concerns about a slowing economy, these same six agencies - the Ministry of Housing and Urban-Rural Development (“MOHURD”),<sup>1</sup> the Ministry of Commerce (“MOFCOM”), the National Development and Reform Commission, the People’s Bank of China, the State Administration for Industry and Commerce and the State Administration of Foreign Exchange (“SAFE”) – issued the *Circular on Adjusting Policies on Real Estate Market Access by Foreign Investors and Related Administration* (关于调整房地产市场外资准入和管理有关政策的通知) (“Circular 122”) lifting a number of these limits with a view to boosting a sluggish market. Circular 122 took immediate effect.

Circular 122 is not the first measure adopted by the Chinese authorities to boost the property market. Over the past 12 months, the Chinese government has taken various such measures. However, these measures targeted and principally benefited domestic investors. Circular 122 is the first measure targeting foreign investors.

We summarize key provisions of Circular 122 below and analyze some of the practical implications for foreign investment in Chinese real estate.

### FIREES DEBT RULES LOOSENER – A LITTLE

Opinion 171 limited the leveraging of foreign investment in Chinese property by imposing a maximum debt to equity ratio specific to foreign-invested real estate enterprises (“FIREEs”). Opinion 171 specified that a FIREE must have registered capital of at least 50% of its total investment amount – meaning in effect that FIREEs can have a maximum one-to-one debt to equity ratio, a limitation to which domestic investors in the property sector as well as foreign investors outside the property sector are not subject. Opinion 171 also imposed the requirement that the registered capital of a FIREE must be fully paid up before it is permitted to borrow.

Circular 122 eliminates both these restrictions, meaning that FIREEs are permitted to use the same debt to equity ratio applicable to foreign investors in other sectors (as high as two-to-one, depending on the amount of the FIREE’s registered capital) and, subject to other related regulatory and lender restrictions, may borrow while some portion of registered capital has not been funded.

<sup>1</sup> Formerly known as the “Ministry of Construction.”

# Client Alert

Undoubtedly, these are positive changes. But equally, they may not be seen by foreign investors as dramatic improvements, for a number of reasons:

1. *The relaxation of the leverage ratio will only gradually affect loan financing of foreign-invested real estate projects.* Reducing the registered capital of an existing FIREE is fraught with technical and practical difficulties, and increasing a FIREE's total investment is also subject to government approval and registration formalities. The more relaxed leverage ratio will nonetheless benefit FIREEs established in the future, as well as existing FIREEs that undertake capital increases in the future.
2. *Circular 122 did not abolish a more fundamental restriction on FIREE borrowing, namely the prohibition on FIREEs' use of cross-border debt financing imposed under current SAFE rules.*<sup>2</sup> The leverage ratio is oftentimes not strictly observed in relation to domestic borrowings in the first place. In contrast, SAFE enforces it strictly in connection with cross-border debt (including in the form of offshore shareholder loans and bank loans).
3. *Other material restrictions on the timing of FIREE borrowings remain.* Even if a FIREE can borrow before its registered capital is fully contributed, it still must wait until (a) it has obtained a "land use certificate" for the land that is being developed and (b) its paid-in project development capital exceeds 35% of its total project investment.

The authorities appear still to be concerned about over-leveraging, and may be adopting a wait-and-see approach instead of rushing to abolish other restrictions on FIREE borrowing. Moreover, banks in China may, as a matter of lending practice and its internal policies, maintain lending restrictions on FIREEs.

## "SELF-USE" RESTRICTION ON FOREIGN NATIONALS EASED SLIGHTLY

Opinion 171 had previously limited foreign nationals and PRC branches and representative offices of foreign entities to China property purchases for "self-use" only. Circular 122 restates this restriction. However, Circular 122 does not restate the additional requirement of Opinion 171 that a foreign national must have been resident in China for one year prior to purchasing. Some commentators understand this omission to mean that the one-year residency requirement no longer applies.

*Circular on Further Regulating the Administration of Housing Purchases by Overseas Institutions and Individuals* (关于进一步规范境外机构和个人购房管理的通知) issued by SAFE and MOHURD on November 4, 2010 also limits a foreign national to the purchase of only one residential property as part of the "self-use" restriction. Circular 122 does not expressly confirm or remove this one-property restriction, and thus it is unclear whether the restriction will continue to apply after the issuance of Circular 122. In practice, relevant authorities may take account of the

<sup>2</sup> See the Operational Guidelines for Administration of Registration of Foreign Debts (in Chinese, 外债登记管理操作指引), which is an appendix to the Circular of the SAFE on Distributing the Administrative Measures for Registration of Foreign Debts (in Chinese, 国家外汇管理局关于发布《外债登记管理办法》的通知) promulgated by SAFE on April 28, 2013 and amended on May 4, 2015. Note that such restriction was initially stipulated in the Circular of SAFE on the Distribution of the List of the First Group of Foreign Invested Real Estate Projects that Have Been Filed with the Ministry of Commerce (in Chinese, 国家外汇管理局综合司关于下发第一批通过商务部备案的外商投资房地产项目名单的通知), issued by SAFE on, and effective as of, July 10, 2007, and then abolished on May 13, 2013.

# Client Alert

---

number, as well as the size, of residential properties held by a foreign national in determining whether a proposed purchase is for “self-use”.

## APPROVAL FORMALITIES FOR FIREES SIMPLIFIED

Circular 122 sets out the general objective of simplifying the approval formalities and improving the supervision procedures of FIREEs going forward. However, the only specific measure provided is to permit FIREEs to apply directly to banks, rather than to SAFE, to complete formalities such as the foreign exchange registrations to set up a new FIREE and to open up new capital accounts. This particular measure simply reflects reforms already implemented by SAFE in relation to foreign direct investment in other sectors. It remains unclear how approval formalities (including MOFCOM approval and filing requirements) might be streamlined to help foreign investors execute real estate transactions in China more quickly.

\* \* \*

Circular 122 by itself is unlikely to have a dramatic effect in stimulating foreign investment in Chinese real estate, but it may still be significant as a signal that the Chinese government will at last loosen foreign real estate investment restrictions as the Chinese economy continues to stutter. Implementation of Circular 122 and the announcement of additional liberalization measures should be closely monitored by any investor interested in the Chinese real estate market.

### Contact:

**Marcia Ellis**

+852 25850784

[mellis@mofo.com](mailto:mellis@mofo.com)

**Paul McKenzie**

+86 (10) 5909 3366

[pmckenzie@mofo.com](mailto:pmckenzie@mofo.com)

**Gregory Tan**

+86 (21) 23225218

[gtan@mofo.com](mailto:gtan@mofo.com)

**Maria Wang**

+86 (21) 23225298

[mariawang@mofo.com](mailto:mariawang@mofo.com)

### About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We’ve been included on *The American Lawyer’s* A-List for 12 straight years, and *Fortune* named us one of the “100 Best Companies to Work For.” Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at [www.mofo.com](http://www.mofo.com).

*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.*