Innovation and Exploration on Perpetual Bonds as a Capital Supplement Path of Chinese Commercial Banks

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Abstract

Under the current situation of insufficient capital replenishment of Chinese commercial banks, this article focuses on the emerging capital replenishment tool, perpetual bonds, studies the issuance of perpetual bonds of commercial banks in China's financial market and the path to capital replenishment for Chinese commercial banks, and analyses the restrictive factors of perpetual bonds of Chinese commercial banks in the market circulation. The corresponding solutions are proposed from three aspects: clause setting, issuance conditions and policy environment.

Keywords

Perpetual Bonds; Commercial Banks; Capital Replenishment Path.

1. Introduction

With the rapid development of the financial environment and the gradual transformation of regulatory concepts, China's capital supervision of commercial banks has gradually become stricter. In order to maintain steady development, banks must ensure sufficient capital as the last line of defense against financial risks and increase their own capital adequacy. China's strict financial supervision system will face great challenges. In 2010, the "Basel III" was promulgated, which raised the capital adequacy ratio standards of commercial banks. The degree of innovation in the other Tier-1 capital replenishment tools became the key to the competition of commercial banks. China's other Tier-1 capital replenishment instruments have a single category. As China's emerging other Tier-1 capital replenishment instruments, perpetual bonds have emerged as a new channel for capital replenishment since their issuance on the international market.

With reference to the regulations of the Shanghai Stock Exchange and the Shenzhen Stock Exchange on perpetual bonds, perpetual bonds are theoretically permanent bonds. Generally, they refer to bonds that have no clear maturity date or a very long term, but interest can be paid on a regular basis. Perpetual bonds are essentially a type of credit bonds with no fixed maturity and "nested options" issued in the bond market. They are between ordinary senior debt and ordinary shares, as a hybrid financing tool with the dual nature of bonds and equity.

Based on this background, this article carefully sorts out the current status of perpetual bond issuance in China, summarizes the impact of perpetual bonds on the capital of commercial banks, raises the problems that arise in the process of perpetual bond issuance, and provides practical suggestions on how to promote perpetual bonds to provide capital supplements for commercial banks.

2. Literature Review

Regarding the issuance of perpetual bonds of commercial banks, scholars initially paid attention to the form and essence of perpetual bond issuance of commercial banks and the
related risks of perpetual bonds. With the deepening of research, academia began to study the economic consequences of perpetual bonds of Chinese commercial banks in the market circulation. The circulation of perpetual bonds in commercial banks and the impact on the capital adequacy ratio and capital structure of commercial banks.

The earliest historical record of perpetual bonds is 1648. Since China introduced perpetual bonds in 2013, Chinese academic circles have conducted many studies on the impact of perpetual bonds on the capital of commercial banks. Zhang Jiqiang et al. (2013) [1] believed that the development of perpetual bonds can supplement the capital of financial institutions, the project capital of non-financial companies, and the bonds of restricted companies. Lv Hai (2019) [2] analyzed the capital pressures faced by Chinese commercial banks and the current problems of capital instruments, summarized the innovative practices and experiences of foreign capital instruments, and put forward suggestions for reference by Chinese commercial banks in introducing perpetual bonds. Zhao Hongxuan (2019) [3] compared the driving factors behind the hot and cold changes in perpetual bonds of commercial banks, and put forward regulatory recommendations on the future issuance of perpetual bonds of commercial banks to supplement capital. Liu Xueni and Liu Guocheng (2020) [4] analyzed the change of excess yield before and after the perpetual bond financing event of the Bank of China in the process of studying whether the market accepts perpetual bonds of commercial banks, and determined the economic consequences of the issuance of perpetual bond financing by commercial banks. Yan Yuxin and Ju Hui (2020) [5] analyzed the urgent needs of small and medium-sized commercial banks in China, such as capital supplementation and capital structure optimization and deeply discovered the shortcomings in the perpetual bond issuance of small and medium-sized banks from the perspective of terms setting, issuance standards, investor types, etc.

3. Problems of Perpetual Bonds Affecting the Capital of Commercial Banks

3.1. Perpetual Bond Issuance of Chinese Commercial Banks

3.1.1. Difference in Perpetual Bonds between Commercial Banks and General Corporates

According to different issuers, perpetual bonds can be divided into perpetual bonds of general corporates and perpetual bonds of financial institutions. “conceptual perpetual bonds” such as the renewable corporate bonds launched by Wuhan Metro at the end of 2013 and the perpetual bonds issued by Guodian Power are the main representatives of general corporate bonds. Although this type of bond has some basic characteristics of perpetual bonds, it lacks clear regulations in some aspects. Perpetual bonds of financial institutions can be divided into perpetual bonds of banks, perpetual bonds of securities companies and perpetual bonds of other financial institutions. Among them, China’s first commercial bank perpetual bond was issued by the Bank of China in 2019, with a scale of 40 billion. Based on the internal advantages of perpetual bonds, we will further analyze perpetual bonds. For example, Table 1 compares perpetual bonds of commercial banks with perpetual bonds of general corporates to explore the advantages of perpetual bonds of commercial banks.

3.1.2. Institutional Standards for Issuing Perpetual Bonds of Commercial Banks in China

China has not yet perfected its perpetual bond policy. Only the People’s Bank of China has issued standards for qualified banks that issue perpetual bonds. Professional rating agencies strictly separate the subject ratings of perpetual bond issuers and debt ratings, and they will not be affected by each other. If the issued perpetual bonds have strong equity, the issuer’s capital status will be better improved. The strong equity, long maturity, and weak liquidity of perpetual bonds will lead to a reduction in the bond rating. There is a certain reverse relationship between the essence and the rating of perpetual bonds, which gives investors a full reminder.
Table 1. Difference in perpetual bonds clause between commercial banks and general corporates

<table>
<thead>
<tr>
<th>Issuer issuing purpose</th>
<th>Perpetual bonds of commercial banks</th>
<th>Perpetual bonds of general corporates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issuer</td>
<td>Commercial Banks</td>
<td>Non-financial enterprise</td>
</tr>
<tr>
<td>Issuing purpose</td>
<td>Supplement other Tier-1 capital</td>
<td>Reduce financial leverage</td>
</tr>
<tr>
<td>Redemption clause</td>
<td>After at least 5 years from the date of issuance, the issuer has the right to redeem the bonds in whole or in part on the interest payment date each year.</td>
<td>There is no clear redemption period limit in general.</td>
</tr>
<tr>
<td>Loss absorption clause</td>
<td>When the triggering event occurs, without the consent of the creditor, the bank has the right to directly write down the perpetual debt in whole or in part to replenish the bank's capital.</td>
<td>There is no write-down or share conversion clause, and the corporate can only postpone the repayment of the principal.</td>
</tr>
<tr>
<td>Interest rate jump clause</td>
<td>Must not contain interest rate jump mechanism, investors need to bear the risk of indefinite extension of perpetual bonds.</td>
<td>In order to reduce the difficulty of issuance, an interest rate jump clause is set.</td>
</tr>
<tr>
<td>Deferred/cancelled interest clause</td>
<td>The issuer can cancel the dividends voluntarily, which does not constitute an event of default, and the coupons do not accumulate</td>
<td>Cumulative interest, deferred penalty interest</td>
</tr>
</tbody>
</table>

3.1.3. Perpetual Bond Issuance of Commercial Banks of Different Sizes in China

Chinese commercial banks have issued 73 bank perpetual bonds since the beginning of 2019, with an existing scale of 1.2225 billion yuan, involving 60 banks. Among them, the stock of perpetual bonds of the six state-owned commercial banks is 640 billion yuan, accounting for 52.4%; the issuance of joint-stock commercial banks is 450 billion yuan, accounting for 36.8%; city commercial banks, rural commercial banks, and private banks with more prominent capital replenishment pressures have small issuance scales of perpetual bonds, with stock sizes of 119.9 billion yuan, 10.1 billion yuan, and 2.5 billion yuan respectively. Except for small and medium-sized commercial banks, the main ratings and debt ratings of large state-owned banks and joint-stock banks that issue perpetual bonds have reached AAA standards, which to a certain extent indicates that small and medium-sized commercial banks may potentially reduce the principal or cancel interest payments on perpetual bonds. The possibility is higher than that of state-owned banks and joint-stock commercial banks. In terms of trends, the perpetual bonds of larger commercial banks have higher liquidity and relatively lower credit risk. Therefore, for subscribers, they prefer to choose perpetual bonds with lower credit risks and fixed interest rates. The difference shows a downward trend as the scale becomes larger.

3.2. Impact Mechanism of Perpetual Bonds on the Capital of Commercial Banks

3.2.1. Supplement Other Tier-1 Capital of Commercial Banks and Optimize Capital Structure

Perpetual bonds supplement other Tier-1 capital of banks and increase the capital adequacy ratios at all levels, which can effectively improve the capital structure of commercial banks, so that commercial banks are not limited to using core Tier-1 capital for financing and get into trouble, and improve the ability of commercial banks to deal with daily operations and market risks, to ensure the steady operation of commercial banks. On the one hand, it will help commercial banks break through the bottleneck of equity investment, promote debt-to-equity swaps, and promote the bond market’s corporate financing function. On the other hand, as the government encourages commercial banks credit growth and promotes the expansion of credit scale. Therefore, capital expansion has improved the ability to support the real economy, especially the private, small and micro real economy, and it is conducive to promoting the return of "shadow banking" business, boosting confidence in the capital market, and ensuring
the healthy and stable development of the capital market. Commercial banks can only lay a sufficient and solid capital base, leaving sufficient space for capital to deal with financial risks caused by economic fluctuations and other phenomena, and to prevent systemic financial risks from occurring.

3.2.2. Adjust the Assets-liability Structure to Improve Risk Resistance

The structural contradictions of China’s economic development have become increasingly prominent. Commercial banks blindly chase high in the short-term, resulting in excessive assets-liability structure and serious capital misallocation. If the commercial banks’ asset structure is simply compressed, although the debt situation can be improved to a certain extent, the contraction of the economic aggregate caused at the same time will cause the operational risks of commercial banks, which will lead to security problems in the financial system. Therefore, the focus of commercial banks' deleveraging is to adjust the overall asset-liability structure during the economic downturn. Since there is no clear maturity period for perpetual bonds, when commercial banks are too heavy in debt to repay, perpetual bonds can extend their debt maturity to the utmost extent, and the order of repayment is after ordinary bonds and other debts, and before ordinary shares. The jump in the coupon rate does not constitute an indirect obligation, and is regarded as an equity instrument, which can ensure the long-term source of funds for commercial banks to a certain extent, and support commercial banks to face financial risks effectively and operate steadily.

3.2.3. Broaden the capital replenishment channels of small and medium commercial banks

Small and medium-sized commercial banks have small capital scales and weak anti-risk capabilities. While expanding in scale, small and medium-sized commercial banks lack the strength to replenish capital and are prone to bankruptcy. There are several ways to supplement bank capital through issuance of preferred shares, additional issuance, allotment of shares, convertible bonds, etc. However, the high threshold, long time, and high cost of these channels make it difficult for many small and medium-sized commercial banks to supplement capital through core Tier-1 capital instruments as large commercial banks. Therefore, the issuance of perpetual bonds and secondary capital bonds has become an important way for small and medium-sized commercial banks to replenish their capital. Now in this period of cyclical low interest rates, the issuance of perpetual bonds has become the first choice for some small and medium-sized commercial banks, promoting the gradual return of the banking business of urban commercial banks, rural commercial banks, and rural credit cooperatives to their origins. This action will unblock the transmission channels of China’s monetary policy, provide credit support for small and medium-sized enterprises, promote the development of the real economy, and boost China’s capital market.

3.3. Limiting Factors of the Circulation of Perpetual Bonds of Commercial Banks

3.3.1. Single Perpetual Bond Clause Setting of Commercial Banks

Foreign perpetual bonds have been developed for a relatively long time, the market is relatively more mature, and the design of perpetual bond terms is more flexible. Diversified and flexible clause settings often help enrich the varieties of perpetual bonds and meet the diverse needs of various types of investors. Relatively speaking, in terms of loss absorption methods, China has not really implemented the loss absorption method of equity conversion, and the existing loss absorption method is only write-down. The issuer has the right to write down all or part of the current bonds issued and in existence at that time based on the total par value, without setting permanent write-downs and temporary write-downs based on whether they can be restored, in the case of submitting to the China Banking and Insurance Regulatory Commission and
obtaining consent, but without the consent of the bondholders. In addition, in terms of the design of trigger conditions, Chinese commercial banks followed the low trigger threshold conditions for preferred stocks, that is, the issuer’s core Tier-1 capital adequacy ratio fell to 5.125% (or below). The foreign perpetual bond clauses often set high trigger threshold condition 3 and low trigger threshold condition 4. The coupon rate of high trigger threshold is usually higher for investors to weigh and choose between risks and returns. Therefore, the terms of other Tier-1 capital instruments in China are relatively simple, and it is difficult to meet the risk and return requirements of different investors.

3.3.2. Limited Range of Commercial Banks That Meet the Issuance Standards and Policy Support

In terms of bond ratings, foreign perpetual bond credit ratings are mainly concentrated between BBB+ and A, among which there are more A, and their distribution is more reasonable compared to the situation in China. According to the standards recognized by the People’s Bank of China for China’s perpetual bond issuance banks, an investigation was conducted on China’s listed banks. Among the 29 listed banks in China’s A-shares, 6 of the total assets of city commercial banks did not meet the standards. According to the standards of the China Banking and Insurance Regulatory Commission, among the 29 listed banks, 18 commercial banks meet the conditions, including 5 state-owned commercial banks and 8 joint-stock commercial banks, and only 5 city commercial banks meet the conditions. In addition, a large part of small and medium-sized commercial banks are unlisted banks, and most of these banks are far from the standards set by the People’s Bank of China and the China Banking and Insurance Regulatory Commission. Among the banks that issued perpetual bonds in 2019, three small and medium-sized commercial banks began to issue perpetual bonds after November 2019, and their main ratings and debt ratings were lower than those of other banks. Therefore, in order to protect investor rights and strictly guard against financial risks, China’s perpetual bond issuance standards are excessively high and concentrated. Although China has repeatedly encouraged small and medium-sized commercial banks to replenish capital through perpetual bonds, there are still many small and medium-sized commercial banks that cannot meet the standard that have been rejected from this idea of capital replenishment.

3.3.3. Unclear Relevant Policies

Perpetual bonds of commercial banks have initially entered the Chinese financial market, and China’s legal system for perpetual bonds still needs to be improved. However, when some of the underlying key issues were not clear, perpetual bonds were put into the market. First of all, in terms of laws and regulations, China has not clearly defined the priority level of perpetual bonds, especially the priority relationship between perpetual bonds and preferred stocks. Before the issuance of perpetual bonds in many other countries, the issuer usually agrees in advance on the priority order of the bonds when the company goes bankrupt. Therefore, the order of repayment of foreign perpetual bonds is clearer, which is also an effective way to protect the rights and interests of investors. Secondly, from international experience, financial institutions such as insurance companies, fund companies, pension funds, and asset management companies are the main investors in perpetual bonds. However, there are certain obstacles to investing in perpetual bonds for important investors such as insurance companies, commercial banks, and wealth management subsidiaries of commercial banks in China.

4. Countermeasure

4.1. Improve the Terms of Perpetual Bonds to Meet the Diverse Needs of Investors

Commercial banks should learn from foreign experience and set up flexible and diverse terms to enrich the varieties of perpetual bonds to meet the diverse needs of various types of investors.
In terms of loss absorption methods, we should improve the loss absorption method of conversion as soon as possible, explore the perpetual bonds of the conversion bank to better protect the rights and interests of investors, and set up permanent write-downs and temporary write-downs according to whether they can be restored, combining the classification method of full write-down and partial write-down, which provides a variety of options. In terms of trigger condition design, Chinese commercial banks need to set trigger threshold conditions of different levels and standards for investors to weigh and choose between risks and returns.

4.2. Enrich and Improve the Types and Numbers of Investors

The People's Bank of China and the China Banking and Insurance Regulatory Commission may consider appropriately relaxing the scope of eligible banks for investment in perpetual bond issuance by insurance companies, self-operated banks and other investors. As analyzed above, it is difficult for most small and medium commercial banks to obtain policy support. In order to support the financing of small and micro enterprises, the current government often requires small and medium banks to provide credit to support the development of the real economy due to the "scale discrimination" of large and medium-sized banks. Therefore, it is recommended to reasonably relax the terms and restrictions based on the actual situation of the market, and increase the number of perpetual bond investors under the premise of controllable risks. In addition, referring to the trading methods of ordinary bonds, commercial banks can explore the feasibility of issuing perpetual bonds over the counter, and allow qualified corporate investors and high-net-worth individuals to invest in perpetual bonds after evaluation, further expanding the scope of investors.

4.3. Clarify Relevant Laws, Regulations and System Norms

For new products in the market, with the support of the government, the regulatory authorities should quickly establish and improve the laws and regulations on the issuance of perpetual bonds by commercial banks to protect the rights and interests of investors. For example, to standardize the procedures for holders of perpetual bonds to apply for the issuer’s bankruptcy, they can treat the bond holdings as maturity and participate in the bankruptcy procedures to require them to repay the principal and interest after the issuer’s bankruptcy. In addition, the regulatory authorities should implement various systems such as information disclosure as soon as possible in accordance with market conditions and policy instructions, optimize the issuance process of perpetual bonds, and improve the issuance efficiency.

5. Conclusion

Under the current situation of insufficient capital replenishment at all levels of Chinese commercial banks, this article focuses on the issuance of perpetual bonds, an innovative capital replenishment method, to supplement other banks’ Tier-1 capital, optimize the capital structure of commercial banks, and expand capital replenishment channels for small and medium-sized commercial banks. After a comprehensive analysis of the essence of perpetual bonds, it was found that its deficiencies existed, and corresponding solutions were proposed from the setting of perpetual bond terms, issuance standards and policy environment to support the circulation of perpetual bonds in China’s financial market, effectively supplement the capital of commercial banks and promote the operation of commercial banks.

References


