Baoshang Bank Hybrid Bond Write-Down Demonstrates Loss-Absorbing Features of Hybrid Bonds in China

November 16, 2020

The 100% loss of principal and unpaid interest on the tier-2 capital bond of Baoshang Bank demonstrates how bank hybrid bonds serve their purpose as loss-absorbing instruments in China. On November 13, 2020, Baoshang Bank announced that the 6.5 billion RMB principal of its tier-2 capital bond will be completely written down and the unpaid accumulative interest of 585 million RMB will not be paid. This is the first time that Chinese investors have faced a write-down of principal on a hybrid bond.

The complete loss on the Baoshang Bank hybrid bond complies with the terms of the tier-2 capital bonds. According to the terms of the legal documents, such bonds are supposed to absorb losses when the banking regulator determines a bank as unviable. On November 11, 2020, Baoshang Bank was notified by the People’s Bank of China ("PBOC") and China Banking and Insurance Regulatory Commission ("CBIRC") that non-viability trigger event had happened at the bank, and that its tier-2 capital bond should be written down as required by the contract.

Given that senior creditors had already suffered a material loss from the Baoshang Bank takeover, the write-down of its hybrid bond is in line with our expectations. Baoshang Bank’s tier-2 capital bond (the bank’s only hybrid bond issuance) was issued in 2015, with a principal amount of 6.5 billion RMB and a coupon rate of 4.8%. It is a ten-year bond with an issuer call option after the fifth year. Baoshang Bank is a privately-owned regional bank based in Inner Mongolia Autonomous Region. It was taken over by the government last year due to its very high bad debt ratios which totally wiped out its capital base and led to creditor losses. The mismanagement of Baoshang Bank was the result of years of inappropriate intervention by its largest shareholder and a lack of internal control. Before the government takeover, its biggest shareholder had inappropriately taken 156 billion RMB from the bank, all of which became bad debts. According to the PBOC, without government support, losses to general creditors would have been over 40%. With funding from the PBOC and Deposit Insurance Fund, retail depositors and most institutional creditors did not suffer any loss. A 10% loss was imposed on wholesale creditors with large exposures to Baoshang Bank.

Nevertheless, the write-down of the hybrid bond surprised the domestic market, given the speculation that there would have been a government bailout of some extent for hybrid bond investors in such circumstances. We expect higher interest rates for regional banks’ hybrid bond issuance in the future, as investors can no longer act with certainty when factoring implicit government support into their pricing. We believe this latest incident can help the domestic bond market improve its credit risk awareness, particularly in terms of the difference in credit quality between senior bonds and hybrid instruments.

Hybrid bonds have been very important instruments for banks in maintaining stable capitalization during the COVID-19 outbreak, which resulted in intensive capital consumption and weakening profitability. Chinese banks typically issue two kinds of hybrid bonds in the domestic market, tier-2 capital bonds and perpetual bonds (which are tier-1 capital). In the first ten months of 2020, about 978.7 billion RMB of bank hybrid bonds were issued, among which, 56.2%
was issued by state-owned mega banks, 29.6% by joint-stock banks and 14.2% by regional banks.

Chart 1

**Hybrid Bond Issuance by Banks in the Domestic Inter-bank Market**

In several cases, government support for banks has indirectly helped out hybrid bond investors in recent years. In the cases of Hengfeng Bank and Bank of Jinzhou, both banks’ hybrid bond investors have so far avoided losses thanks to government intervention. Bank of Jinzhou had a non-performing loan (“NPL”) ratio of 7.7%, a special-mention loan (“SML”) ratio of 15.4% (there were also huge amounts of bad debts in its investment portfolio), and a Tier-1 capital adequacy ratio of 6.47% as of end of 2019. Without government support, we believe its hybrid bonds would have faced being written down imminently given its serious bad debt problem. In 2019, the investment company under the Industrial and Commercial Bank of China and two distressed asset management companies (“AMC”) owned by the central government invested in its equity. In 2020, the bank issued new shares to a government-owned entity controlled by the PBOC and a local enterprise owned by the provincial government, and sold off its problematic assets (with a book value of RMB 150 billion) for RMB 45 billion to a PBOC-controlled entity. Upon completion of all these transactions, the government-owned entity controlled by the PBOC held about 37.69% of the total equity of Bank of Jinzhou. As of the end of 2020 Q2, Bank of Jinzhou had an NPL ratio of 1.8%, an SML ratio of 5.9%, and a tier-1 capital adequacy ratio of 6.94%, marking a significant turn-around compared to the dire situation in 2019. So far, its tier-2 capital bond issued in 2018 has been paying interest on time and in full.
Government support has also been critical to the credit quality of the hybrid bonds issued by Hengfeng Bank. The bank issued 8 billion and 15 billion RMB worth of tier-2 capital bonds in 2014 and 2015 respectively. It had an NPL ratio of 28.4% and a tier-1 capital adequacy ratio of -13.65% as of the end of 2018. In December 2019, it issued 100 billion shares, 60 billion of which were subscribed for by Central Huijin Investment Ltd. A Shandong-based state-owned distressed AMC subscribed for 36 billion. After this capital injection, Hengfeng Bank's equity reached 111.21 billion RMB, representing an increase of almost ten times on its equity, and its capital adequacy ratio reached 9.68%. Its tier-2 capital bond issued in 2014 was paid back in full in December 2019 using the issuer’s call option after the fifth year. The other tier-2 capital bond issued in 2015 has been paying its interest on time and in full so far.
We believe the complete loss on Baoshang Bank’s hybrid bond is a rare incident and the majority of outstanding bank hybrid bonds can maintain stable credit quality given the steady outlook of the overall banking sector in China. However, this incident does raise concern for investors who hold hybrid bonds of small and mid-sized banks with inadequate capital bases and high bad debt ratios, since government support, which is typically factored into assessments of bank credit in China, may not be available for hybrid instruments issued by these banks.
The unstable asset quality and capital bases of small and mid-sized banks makes it difficult for investors to assess the risk of hybrid bonds, given the fact that banks’ tier-2 capital bonds typically have ten-year terms. In addition, a few small and mid-sized banks may have data quality problems and may have tried to conceal real bad debt information from investors, which has made it more difficult to assess whether a hybrid bond faces imminent writing-down risk or not. When Baoshang Bank issued its hybrid bond in 2015, it reported a tier-1 capital adequacy ratio of 10.36% and an NPL ratio of 1.6%, which did not imply any significant risk. But the bank then stopped disclosing its financial information in 2017, indicating serious problems. CBIRC’s efforts to improve banks’ asset credit risk classification practices in recent years have mitigated such risk to some degree.

This report does not constitute a rating action.
Appendix: Related Methodologies & Research

- S&P Global (China) Ratings General Considerations On Rating Modifiers And Relative Ranking
- Understanding S&P Global (China) Ratings General Considerations on Rating Modifiers and Relative Ranking Methodology
- Risk Differentiation Exists Between Banks’ Hybrid Capital Instruments and Senior Bonds
This document is prepared in both English and Chinese. The English translation is for reference only, and the Chinese version will prevail in the event of any inconsistency between the English version and the Chinese version.

Copyright © 2020 by S&P Ratings (China) Co., Ltd. All rights reserved.

S&P Ratings (China) Co., Ltd. ("S&P Ratings") owns the copyright and/or other related intellectual property rights of the abovementioned content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content). No Content may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of S&P Ratings. The Content shall not be used for any unlawful or unauthorized purposes. S&P Ratings and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively "S&P Parties") do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P Ratings' opinions, analyses, forecasts and rating acknowledgment decisions (described below) are not and should not be viewed as recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P Ratings assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P Ratings does not act as a fiduciary or an investment advisor except where registered as such. While S&P Ratings has obtained information from sources it believes to be reliable, S&P Ratings does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

S&P RATINGS IS NOT PART OF THE NRSRD. A RATING ISSUED BY S&P RATINGS IS ASSIGNED ON A RATING SCALE SPECIFICALLY FOR USE IN CHINA, AND IS S&P RATINGS' OPINION OF AN OBLIGOR'S OVERALL CREDITWORTHINESS OR CAPACITY TO MEET SPECIFIC FINANCIAL OBLIGATIONS, RELATIVE TO THAT OF OTHER ISSUERS AND ISSUES WITHIN CHINA ONLY AND PROVIDES A RANK ORDERING OF CREDIT RISK WITHIN CHINA. AN S&P RATINGS' RATING IS NOT A GLOBAL SCALE RATING, AND IS NOT AND SHOULD NOT BE VIEWED, RELIED UPON, OR REPRESENTED AS SUCH. S&P PARTIES ARE NOT RESPONSIBLE FOR ANY LOSSES CAUSED BY USES OF S&P RATINGS' RATINGS IN MANNERS CONTRARY TO THIS PARAGRAPH.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P Ratings reserves the right to assign, withdraw or suspend such acknowledgement at any time and in its sole discretion. S&P Ratings disclaims any duty whatsoever arising out of the assignment, withdrawal or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P Ratings keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P Ratings may have information that is not available to other S&P Ratings business units. S&P Ratings has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P Ratings may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P Ratings reserves the right to disseminate its opinions and analyses. S&P Ratings' public ratings and analyses are made available on its Web site www.spgchinaratings.cn, and may be distributed through other means, including via S&P Ratings' publications and third-party redistributors.