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S&P Global
China Ratings

Credit Analysis of China's Four G-SIBs' TLAC-Eligible Non-Capital Bonds

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ANALYSTS

Xiaochen Luan, CFA, FRM
Beijing
Collins.Luan@spgchinaratings.cn

Ying Li, CFA, FRM
Beijing
Ying.Li@spgchinaratings.cn

We expect the issuance of non-capital bonds to play an important role in ensuring China's 4 G-SIBs meet total-loss-absorbing capacity (TLAC) standards[1]. At the end of April 2022, the People's Bank of China (PBoC) and China Banking and Insurance Regulatory Commission (CBIRC) jointly issued a notice on TLAC-eligible non-capital bonds issued by global systemically important banks (G-SIBs). The notice follows TLAC-related management measures for G-SIBs which were released by the PBoC, CBIRC and Ministry of Finance in October 2021, and clarifies the key attributes and issuance regulations applicable to TLAC-eligible non-capital bonds.

Based on their attributes, we expect TLAC-eligible non-capital bonds issued by China's 4 G-SIBs to be very high (AA_{spc}+). This would be slightly lower than the four mega banks' senior unsecured bonds (AAA_{spc}), but higher than their Tier 2 capital bonds (AA_{spc}) and perpetual bonds (A_{spc}).

According to the April 2022 notice, TLAC-eligible non-capital bonds refer to bonds issued by G-SIBs to meet TLAC requirements. They are issued with the purpose of absorbing losses and are not counted in commercial banks' capital bases. The PBoC has said such bonds should be treated as financial bonds by issuers in terms of management scope.

Risks among banks' senior unsecured bonds, TLAC-eligible non-capital bonds and hybrid bonds vary, depending on a number of factors. These include likelihood of government support during crisis, the bonds' loss-absorbing characteristics and our expectation on the banks' capital adequacy. We expect the four mega banks to maintain sufficient capital, and thus government support and the bonds' loss-absorbing attributes are the driving factors of their credit quality.

For China's 4 G-SIBs , we believe their TLAC-eligible non-capital bonds' default risk is very low. Given their role as a buffer for more senior obligations, TLAC-eligible non-capital bonds have slightly lower credit quality than senior unsecured bonds. While TLAC-eligible non-capital bonds can be written off or converted into common equity, this is only possible once the bank triggers the point of nonviability (PONV) and enters into resolution, all Tier 2 capital instruments have been written down or converted. We generally do not make any notching adjustments to reflect such write downs or common equity conversions. In addition, we would expect the four mega banks' TLAC-eligible non-capital bonds to receive government support.

In our view, China's 4 G-SIBs have the highest credit quality among Chinese banks. They are likely to receive extraordinary central government support in a crisis scenario, giving them very high issuer credit quality. Our issuer credit ratings on China Construction Bank and Bank of China are both AAA_{spc}, with stable outlooks.

Considering the support policies already in place for non-capital debt instruments, the four mega banks are not under huge pressure to comply with the TLAC standards, with no impact expected on credit supply. The management measures released in October 2021 stipulate that Chinese G-SIBs' TLAC should reach a minimum of 16% of their risk-weighted assets by the start of 2025 and 18% by the beginning of 2028. The TLAC leverage ratio (under Basel III) should reach 6% by the start of 2025 and 6.75% by the beginning of 2028. According to our static calculations, the total amount

[1] Throughout the rest of this report, such bonds are referred to as "TLAC-eligible non-capital bonds".

of additional capital and non-capital debt instruments needed to meet the TLAC requirements for 2025 for the four mega banks would be around 1.8 trillion RMB.

Capital generated from earnings, improved asset and liability management and issuance of hybrid bonds and TLAC-eligible non-capital bonds can help China's 4 G-SIBs meet TLAC requirements. We expect a large proportion of the TLAC requirements to be met through issuance of TLAC-eligible non-capital bonds. Compared with hybrid bonds (perpetual bonds and Tier 2 capital bonds), the TLAC-eligible non-capital bonds offer more favorable terms to investors and lower credit risk. We expect such bonds to have lower issuance costs for the banks, making them a more economical solution to complying with TLAC standards .

Table 1

Differences in Credit Quality Among Different Types of Bonds

	Issuer/Issue Rating	Notes
Stand-alone credit profile (SACP)	aa_{spc}	Does not include extraordinary government support in a crisis.
Government support	+2	
Issuer credit rating	AAA_{spc}	SACP + government support.
Senior unsecured bonds	AAA_{spc}	As a senior bond, the issue rating is equal to the entity's ICR and no additional notching adjustments are made.
TLAC-eligible non-capital bonds		
Notching starting point	ICR (AAA_{spc})	We believe TLAC-eligible non-capital bonds issued by mega banks may receive government support. Their ICRs are used as the starting point for notching.
Notching adjustment	-1	The one-notch downward adjustment reflects the bond's subordination clauses. TLAC-eligible non-capital bonds are junior to the excluded liabilities (as specified by the G-SIB TLAC management measures) and, if they meet all criteria, are senior to capital instruments at all levels. TLAC-eligible non-capital bonds contain provisions for write downs or equity conversions. When a G-SIB triggers PONV and enters into resolution, all Tier 2 capital instruments are written down or converted into common equity, the PBoC and CBIRC requires the bank to write down or convert its TLAC-eligible non-capital bonds in part or in whole. However, since such an action would only be implemented at the PONV, we generally do not make corresponding adjustments.
Issue rating	$AA_{spc}+$	
Tier 2 capital bonds		

	Issuer/Issue Rating	Notes
Notching starting point	ICR (AAA_{spc})	We believe Tier 2 capital bonds issued by mega banks may receive government support, and we take the entity's ICR as the starting point for notching.
Notching adjustment	-2	Two-notch downward adjustment to reflect: 1) subordination clauses, 2) principal write down/common equity conversion.
Issue rating	AA_{spc}	
Perpetual debt instruments		
Notching starting point	SACP (aa_{spc})	We generally take the entity's SACP as the starting point for perpetual bonds' notching. We consider such bonds as Tier 1 capital and believe there is uncertainty over government support in a crisis.
Notching adjustment	-3	Three-notch downward adjustment from SACP to reflect the following: 1) subordination clauses, 2) principal write-down/common equity conversions, and 3) coupon deferral/cancellation terms.
Issue rating	A_{spc}	

Note: Examples of notching adjustments are based on the terms of current bonds issued in the market. Even if bonds are of the same type as the above examples, any variation in the bond's terms would generally result in differences in notching applied.

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Appendix 1: Analytical Approach to FIs' Hybrid Capital Instruments

Hybrid bonds typically combine both debt and equity characteristics. We consider a security to be a hybrid capital instrument if it can absorb losses without causing a legal default or liquidation of the issuer. Examples of such loss absorption include: (1) deferral of the coupon; (2) write-down of principal; or (3) conversion into common equity or another hybrid capital instrument.

Because of the loss absorption features of hybrid instruments, we believe their credit quality is lower than senior unsecured bonds issued by the same issuer, thus their issue ratings should be different from the ratings on the senior unsecured bonds issued by the same issuer.

Our approaches to rating hybrid instruments are documented in our criteria (S&P Global (China) Ratings General Considerations On Rating Modifiers And Relative Ranking), and explained further in our related commentary (Understanding S&P Global (China) Ratings General Considerations on Rating Modifiers and Relative Ranking Methodology). Our typical approach can be summarized in the following table.

Table 2

How to Rate Hybrid Instruments issued by a Financial Institution

Step		No. of Notches
Step 1: Decide the starting point for notching	To assign a rating to a financial institution hybrid capital instrument, we deduct notches from our starting point. We typically assign a rating to a hybrid capital instrument by notching down from the institution's stand-alone credit profile ("SACP"), except in the following situations, where the starting point is the issuer credit rating ("ICR"): If the institution has group support incorporated into its ICR and we expect group support to be readily available to the issuers' hybrid bonds, such that the hybrid would not absorb losses; If the institution has government support incorporated into its ICR and we expect government support to be readily available to the issuers' hybrids such that the hybrid would not absorb losses; If the ICR on an institution is lower than the SACP; or Any other circumstances where we believe ICR is a more reasonable starting point than SACP.	
Step 2: Standard notching	Our notching starts with standard notching, which is the result of the following three steps.	Typically deduct no more than three notches in total
Step 2a：For contractual subordination	Whenever the instrument is subordinated to senior unsecured debt in resolution or liquidation. Notching does not vary for different subcategories of contractual subordination. For example, banks' perpetual bonds are more deeply subordinated than Tier 2 capital bonds, but the notching for contractual subordination is one for both perpetual bonds and Tier 2 capital bonds.	Typically deduct one notch
Step 2b: For the risk of a partial or untimely payment of coupon	Whenever the instrument has a coupon deferral clause that would lead to coupon deferral or cancellation.	Typically deduct one notch
Step 2c: For the risk of conversion into common equity or a principal write-down	Whenever the instrument has a mandatory contingent capital clause leading to common-equity conversion or a principal write-down, or both.	Typically deduct one notch

Step		No. of Notches
Step 3: Additional notching	Whenever the instrument has loss absorption risks that neither our assessment of the starting point nor the standard notching in Steps 2 fully capture. This typically happens when the instrument has significant loss absorption risk due to the issuer having material capital shortages.	Deduct one or more additional notches, depending on the likelihood of nonpayment on the instrument.

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We believe most mainstream domestic banks are likely to receive timely government support in times of stress, but the potential level of support their hybrid bonds would receive is more uncertain than their senior debts. Our analysis of possible government support for hybrid bonds is mainly driven by the following factors:

- The nature of the instruments. Typically, we believe Tier 2 capital bonds are more likely to receive government support than perpetual bonds, because the latter is Tier 1 capital with higher capital contents.
- The ownership of the banks. We generally believe that hybrid instruments issued by state-owned banks that serve important roles for the government are more likely to receive government support for their hybrid bonds than privately-owned banks.
- The systemic importance of the banks. Typically, we would expect hybrid instruments issued by systemically important banks to be more likely to receive government support for their hybrid bonds compared to smaller banks.

When we believe a specific hybrid instrument of a bank may not have access to government support, we typically start our hybrid bond notching from the bank's SACP (group support is not considered in this case). In cases where we believe a specific hybrid instrument may have access to government support, we typically start our hybrid bond notching from the bank's ICR, which already incorporates our government support considerations.

Appendix 2: Related Methodologies and Research

Related Methodologies and Commentaries

- S&P Global (China) Ratings Financial Institutions Methodology.
- Understanding S&P Global (China) Ratings Financial Institutions Methodology
- 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

Related Sector Research

- Risk Differentiation Exists Between Banks' Hybrid Capital Instruments and Senior Bonds
- Baoshang Bank Hybrid Bond Write-Down Demonstrates Loss-Absorbing Features of Hybrid Bonds in China
- Rating Approach on Hybrid Bonds Issued by Chinese Financial Institutions

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