

# More Small and Medium-Sized Banks Not Exercising Tier 2 Bond Call Options Amid Rising Risk

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2021 and 2022 have seen a significant increase in small and medium-sized banks choosing not to redeem their tier 2 capital bonds. For some city banks and rural banks, risks around tier 2 capital bonds have increased.

China's city banks and rural banks started issuing tier 2 capital bonds in 2013. Most follow a 5+5-year tenor, with most banks exercising call options after five years.

In 2018, Tianjin Binhai Rural Commercial Bank did not redeem tier 2 capital bonds issued in 2013, becoming the first bank to do so. Since then, this has become a growing trend: in 2019 there were 3 banks that chose not to call in such bonds, 5 in 2020 and 18 in 2021. As of August 2022, this year has seen 13 banks decide not to exercise their call options. 38 banks have done so in total, on 41 bonds. All the banks are small and medium-sized banks and comprise 8 city banks and 30 rural banks (see Table 1 for details).

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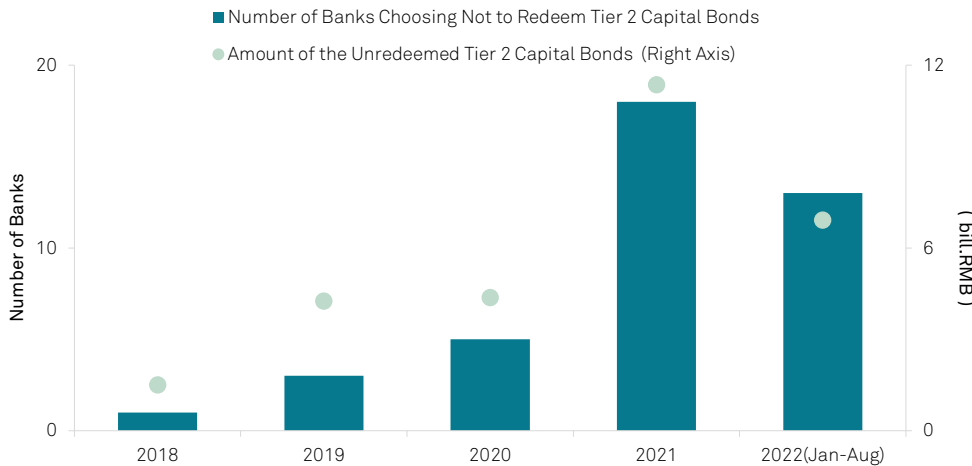
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Chart 1

## Overview of Banks Choosing Not to Redeem Tier 2 Capital Bonds



Source: Wind, collected and adjusted by S&P Global (China) Ratings.

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Banks with sufficient capital usually exercise their issuer call option after the fifth year. Choosing not to is usually a sign of capital pressure, with asset quality and profit indicators generally weaker than the industry average.

5 of the banks that didn't redeem their bonds have not yet disclosed their 2021 annual reports, another signal of insufficient regulatory capital. By the end of 2021, the average NPL ratio of the 38

banks (excluding the 5 that had not yet disclosed their annual reports) was 3.15%, with average SML ratio of 7.93%. Both are higher than their respective industry averages (1.73% and 2.31%).

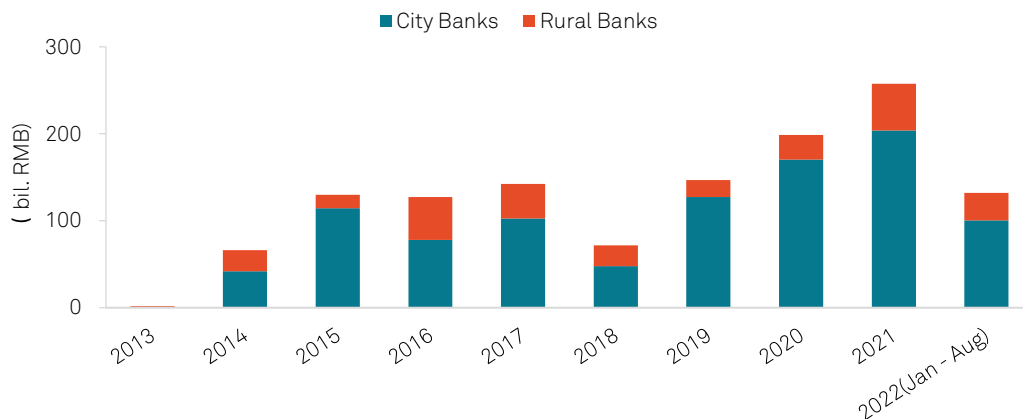
The banks' average ROE in 2021 was only 3.31%, far lower than the industry average of 9.64%. At the same time, we also note that many of the banks had been active in efforts to clean up legacy bad debts in recent years, seeing improvements in disclosed asset quality.

Due to their high bad debt levels and potentially insufficient provisioning, actual capital of small and medium-sized banks (which on paper meet regulatory requirements) may be weaker than disclosed data suggests. Data disclosed by some of the 38 banks would suggest healthy financial indicators that can assure stable adherence to regulatory requirements. Such banks' actual capital adequacy may in fact lag behind the data they have disclosed.

While this "non-redemption" trend has been on the rise since 2021, city banks and rural banks have continued to issue a significant amount of hybrid bonds. That being said, of the 38 banks only 4 has issued new hybrid bonds after deciding not to call in their tier 2 bonds. The last two years have seen many medium and high-risk banks become more reliant on local governments to supplement capital. For more, see [LRG Special Bonds an Important Source of Capital Support for At-Risk Banks](#).

Chart 2

### Overview of New Hybrid Bond Issuances by City Banks and Rural Banks



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The Baoshang Bank case is a prime example of how tier 2 bonds can play a loss-absorbing role, after its tier 2 bonds were completely written off. On November 13, 2020, Baoshang Bank announced it would write down principal on its 6.5 billion RMB tier 2 capital bonds and would not pay accrued interest (about 586 million RMB). This was the first and only time in the domestic market that such bonds had been fully written off.

In our opinion, considering the high debt attributes of tier 2 capital bonds, we would expect government intervention on such debt (provided that the bank is important enough to receive government support). In such cases, default risk on such debt is still controllable.

In recent years, government support has, in some cases, involved indirect support for banks' capital replenishment bonds. For Hengfeng Bank and Jinzhou Bank, investors in tier 2 capital bonds have so far avoided losses due to government intervention.

In 2014 and 2015, Hengfeng Bank issued 8 billion RMB and 15 billion RMB in tier 2 capital bonds respectively. By the end of 2018, the bank's NPL ratio was 28.4%, and its tier 1 capital adequacy ratio was -13.65%. A government bailout followed serious insolvency at the bank. In December 2019, the bank issued 100 billion common stock shares, 60 billion of which were acquired by Central Huijin Investment Co., Ltd. and 36 billion by Shandong Financial Asset Management Co., Ltd. This injection of capital saw shareholders' equity reach 111.21 billion RMB, and its capital

adequacy ratio returned to 9.68%. The abovementioned 2014 and 2015 bonds were fully repaid after the issuer exercised an early-call option.

According to our methodology, tier 2 capital bonds' credit quality is usually two or more notches lower than the bank's issuer credit quality, due to a subordination clause or principal write-down/conversion into common equity clause. From our desktop analysis, the indicative credit quality of uncalled tier 2 capital bonds ranges from [bb<sub>spc</sub>] to [b<sub>spc</sub>] categories. Considering government support, we expect risks around such bonds' principal write-down/conversion into common equity to be controllable after a few years. However, risks may emerge for certain banks.

Table 1

## Financial Indicators of 38 Banks That Did Not Exercise Call Option on Tier 2 Capital Bonds, 2021

( % )	SML Ratio	NPL ratio	Provisioning / (NPL + SML)	ROE	Capital adequacy ratio
Tianjin Binhai Rural Commercial Bank	4.62	2.60	44.64	2.62	16.41
Ningbo Yinzhou Rural Commercial Bank	1.86	2.05	93.71	10.53	15.72
Linshang Bank	4.51	2.62	54.44	4.35	13.30
Guangdong Nanyue Bank	6.60	1.62	47.03	1.96	13.14
Jiutai Rural Commercial Bank	3.00	1.88	61.06	8.33	11.63
Guiyang Rural Commercial Bank	9.40	2.00	34.70	10.05	11.60
Anhui Tongcheng Rural commercial Bank	3.24	5.85	53.31	2.17	11.67
Bank of Shizuishan	5.25	2.30	44.35	4.44	12.44
Dalian Rural Commercial Bank	14.41	4.24	17.16	0.74	Not available
Shandong Zhucheng Rural Commercial Bank	6.04	1.33	27.21	7.00	12.40
Hubei Xianning Rural Commercial Bank	15.74	4.34	29.75	10.45	13.25
Hubei Xiangyang Rural Commercial Bank	0.78	2.46	143.82	7.75	12.05
Bank of Chaoyang	Not available	Not available	Not available	0.17	Not available
Anhui Lujiang Rural Commercial Bank	0.67	2.44	144.64	14.24	12.37
Shandong Laizhou Rural Commercial Bank	16.65	3.50	23.17	0.88	10.96

Hebei Tangshan Rural Commercial Bank	12.50	2.92	28.43	6.76	13.99
Shandong Yucheng Rural Commercial Bank	5.98	2.46	44.50	3.92	11.09
Bank of Dandong	Not available	Not available	Not available	Not available	Not available
Shandong Zhangdian Rural Commercial Bank	4.82	1.40	40.16	7.99	15.98
Hubei Qianjiang Rural Commercial Bank	5.58	2.82	63.83	10.76	12.65
Shandong Yuncheng Rural Commercial bank	5.86	1.88	44.24	10.06	13.32
Bank of Fushun	Not available	Not available	Not available	Not available	Not available
Lu'an Rural Commercial Bank	1.02	2.46	113.74	6.60	11.09
Liaoyang Liaodong Rural Commercial Bank	23.18	11.52	15.25	(5.20)	8.43
Liaoning Donggang Rural Commercial Bank	15.70	1.31	23.24	7.18	12.65
Qinghai Datong Rural Commercial Bank	1.77	2.87	107.09	6.08	17.05
Jilin Jiaohe Rural Commercial Bank	30.41	6.36	17.64	(54.31)	1.74
Bank of Yingkou	Not available	Not available	Not available	Not available	Not available
Shandong Qihe Rural Commercial Bank	7.92	3.35	46.55	6.30	11.15
Shandong Juxian Rural Commercial Bank	10.49	2.47	30.94	6.04	11.50
Shandong Anqiu Rural Commercial Bank	6.51	1.02	29.27	6.94	11.18
Tongling Rural Commercial Bank	6.64	7.64	28.79	5.86	12.11
Shanxi Bank	9.11	3.29	38.17	(23.47)	13.07
Shandong Guangrao Rural Commercial Bank	Not available	Not available	Not available	Not available	Not available
Fuyang Yingdong Rural Commercial Bank	0.72	4.33	133.61	4.18	13.26
Huangshi Rural Commercial Bank	5.47	2.58	62.87	8.92	13.03

Shanxi Yuncheng Rural Commercial Bank	2.79	2.07	64.36	4.72	11.23
Yanbian Rural Commercial Bank	12.72	2.10	22.28	4.54	11.86

Note: "not available" indicates that the bank has not disclosed relevant data for 2021.

Source: Wind, public information of banks, collected and adjusted by S&P Global (China) Ratings.

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