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S&P Global
China Ratings

Risk Differentiation Exists Between Banks' Hybrid Capital Instruments and Senior Bonds

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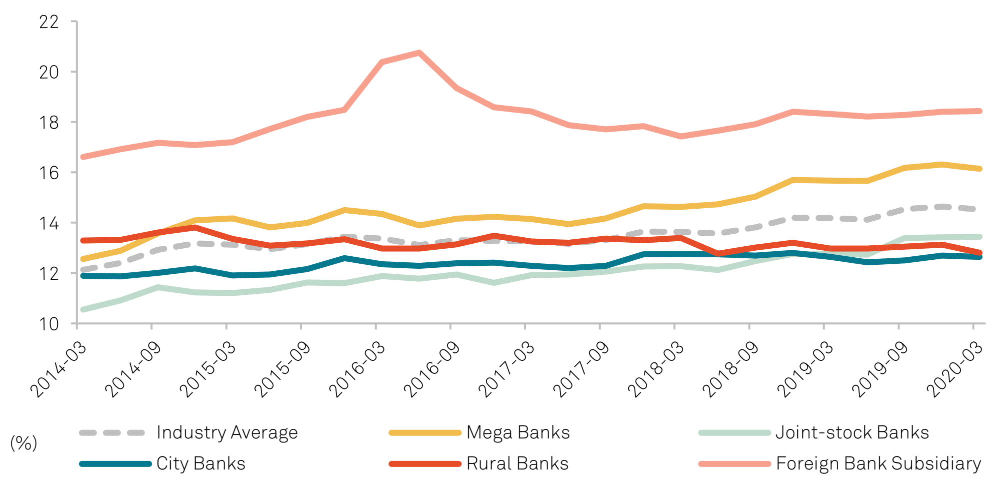
As COVID-19 increases pressure on capital in the banking sector, we expect more hybrid capital instruments to be issued by Chinese banks this year. We believe substantial risk differentiation exists between senior unsecured bonds and hybrid capital instruments, given the loss-absorbing feature of the latter. Appropriate rating differentiation of banks' senior bonds, tier-2 capital bonds and perpetual bonds in the domestic market will help investors properly assess the risk associated with hybrid instruments.

We expect pressure on capitalization to increase this year as banks pump credit into the real economy as part of efforts to cope with the effects of COVID-19.Within the banking sector, small and mid-sized banks are under the highest capital pressure. As of the end of the first quarter of 2020, the average capital adequacy ratio of city banks was 12.65%, while that of rural banks was 12.81%, 1.88 and 1.72 percentage points lower than the industry average respectively. The government announced in the 2020 Government Work Report that it would prioritize improvements to the capitalization of small and mid-sized banks.

Chart 1

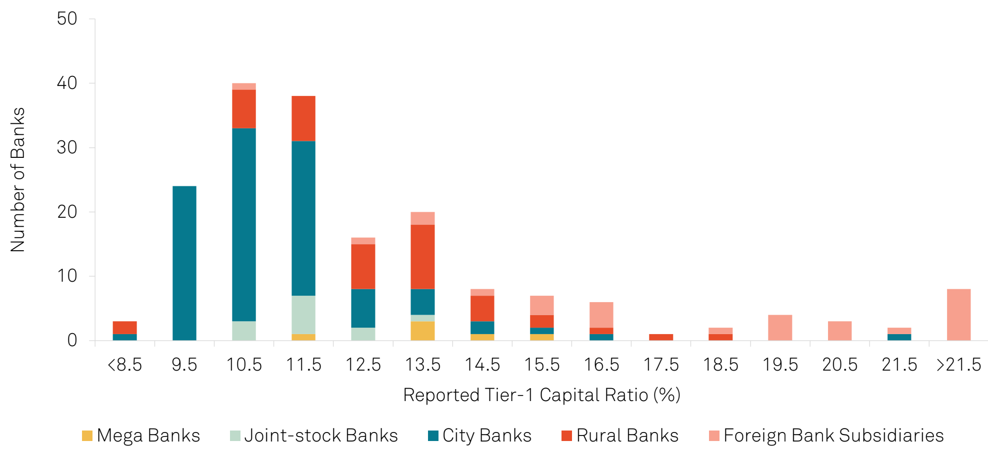
Reported Capital Adequacy Ratio



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

Chart 2

Reported Tier-1 Capital Ratio of Major Domestic Banks as of End of 2019

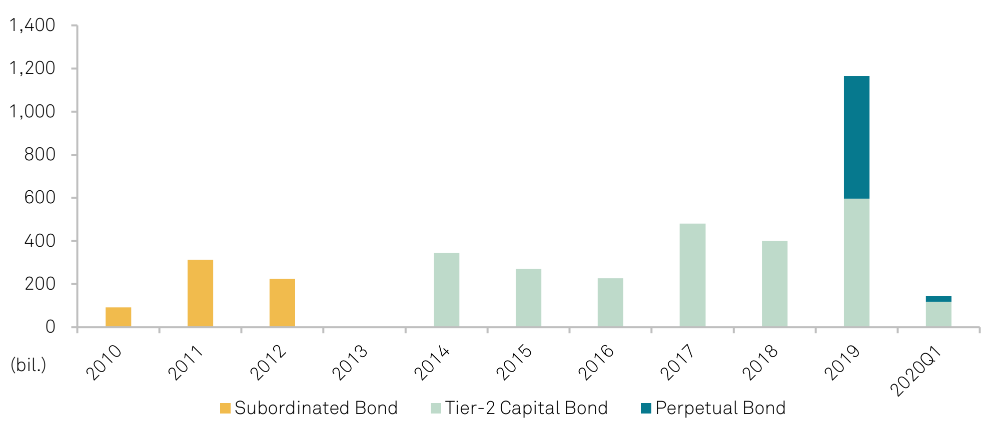


Source: Wind, collected and adjusted by S&P Global (China) Ratings.

Declining profitability has weakened the banking sector's internal capital generation capacity, and we anticipate that the issuance of hybrid capital instruments may play an important role in maintaining sound capitalization this year. 2019 saw a rapid uptick in hybrid issuance among Chinese banks, and we expect that momentum to continue in 2020. The hybrid capital instruments issued by Chinese banks in domestic market in recent years have mainly included tier-2 capital bonds (which are classified as tier-2 capital) and perpetual bonds (which are classified as additional tier-1 capital).

Chart 3

Hybrid Bond Issuance of Commercial Banks in China



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

Compared to senior unsecured bonds, hybrid bonds can absorb loss based on their terms and conditions. Hybrid capital instruments may have a mandatory contractual going-concern trigger linked to regulatory capital ratio requirements. The Financial Stability Board (FSB) has specific provisions on qualified capital instruments when assessing total loss-absorbing capacity

("TLAC"). At present, hybrid instruments issued by Chinese banks are qualified capital instruments in TLAC assessment.

According to our recently updated commentary titled "Understanding S&P Global (China) Ratings General Considerations on Rating Modifiers and Relative Ranking Methodology", we typically consider an instrument to be a hybrid capital instrument if, without causing a legal default or liquidation of the issuer, it can absorb losses or conserve cash. Examples of such loss absorption or cash conservation include: (1) deferral of the coupon; (2) write-down of principal; or (3) conversion into common equity or another hybrid capital instrument.

We may notch down once or twice for subordination and adjust down the rating by one more notch to reflect deferral of payment risk. If we consider that payment risk is not adequately captured in one notch, particularly when the issuer has relatively low credit quality, we may apply wider notching at issuance, as deferral risk is generally higher for those with low credit quality.

We generally assign an issue credit rating to a hybrid capital instrument by notching down from the issuer credit rating (ICR) on the issuer. That said, we may exclude any element of support that we do not expect to apply to the hybrid. For example, if the ICR includes any uplift for potential extraordinary group or government support that we do not expect to be applied to the hybrid, we may notch down from the standalone credit profile (SACP) instead.

Our ratings on banks' hybrid instruments reflect the loss-absorbing features and related risks of such instruments through two steps. First, we consider the starting point for notching, which typically reflects our view on whether government support is available for banks' hybrid instruments or not. Second, we consider the number of downward notch adjustments from the starting point.

In terms of government support, in our view, thanks to the relatively weak capital nature of tier-2 capital bonds, government support may be directed to such bonds. Therefore, if we believe that a government may provide support to a bank's tier-2 capital bonds, the starting point for notching may be the bank's ICR, which may have incorporated government support for that particular bank. In contrast, we typically don't assume perpetual bonds will receive government support. This is because perpetual bonds are tier-1 capital with strong capital nature, and we generally believe that the regulator's intention is to use perpetual bonds to absorb possible losses of banks, therefore, we typically don't assume government support for perpetual bonds. As a result, the starting point for the notching of perpetual bonds is generally the bank's SACP, which doesn't incorporate extraordinary government support.

The number of notching adjustments for hybrid capital instruments are based on both the terms and conditions of the security and the actual capitalization of an institution. Notching for hybrid instruments issued by banks may generally combine:1) one or two notches for subordination; 2) one or more notches to reflect the risk of coupon deferral/cancellation; and 3) additional notching to reflect the risk of common equity conversion or principal write-down under any mandatory contingent capital clause.

We believe there is a distinctive credit risk difference between tier-2 capital bonds and perpetual bonds regarding the securities' terms and conditions. Compared to tier-2 capital bonds, perpetual bonds typically have more clauses which are potentially more negative for bond investors. Perpetual bonds are subordinated to deposits, senior bonds and tier-2 capital bonds. In addition, perpetual bonds have no maturity date while tier-2 capital bonds typically have a term of no less than five years. Furthermore, perpetual bonds issued by Chinese banks typically allow coupon cancellation without mandatory trigger event, while coupon cancellation of Tier 2 capital bonds typically occurs only after such trigger event happens.

Our ratings reflect the risk differentiation among perpetual bonds, tier-2 capital bonds and senior unsecured bonds. For example, if a bank has an SACP of a_{spc} and an ICR of AA_{spc} thanks to a three-notch uplift for government support, its tier-2 capital bonds may probably be rated no higher than A_{spc}+ due to a two-notch downward adjustment for (1) subordination clause and (2) principal write-down/common equity conversion clause from its ICR of AA_{spc} (if we believe extraordinary government support is available for its tier-2 capital bonds). Meanwhile, its perpetual bonds may probably be rated no higher than BBB_{spc}, which is the result of a three-notch downward adjustment for (1) subordination clause, (2) principal write-down/common equity conversion clause and (3) coupon cancellation clause from its SACP of a_{spc} (as we typically don't expect government support for perpetual bonds). Meanwhile, the bank's senior unsecured bonds would probably be rated AA_{spc}, the same as its ICR.

If a bank's regulatory capital ratio is under pressure, which may be demonstrated by a low ICR/SACP, and the loss absorption trigger is likely to be activated, we may conduct additional notching in addition to the standard notching based on the relevant terms and conditions in order to fully capture the risk of the hybrid instruments of an undercapitalized bank.

Related Research:

Commentary: Understanding S&P Global (China) Ratings General Considerations on Rating Modifiers and Relative Ranking Methodology, June 29,2020

This article does not constitute a rating action.

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.