

Risk Management of Commercial Banks in China subordinated debt

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Abstract

Subordinated debt, as an active debt instrument of commercial banks, has been widely accepted and favored by the international banking community in recent years as an important measure for commercial banks to raise funds. Subordinated debt has played an active role in the steady operation and sustainable development of commercial banks. At present, commercial banks in our country have lower capital adequacy ratio and a single capital structure with a very low proportion of auxiliary capital. This paper reviews the domestic and foreign research literature, summarizes the relevant theories, summarizes the issuance of subordinated debt of commercial banks at home and abroad, analyzes the various risks existing in commercial banks in China at present, and proposes relevant countermeasures and suggestions. Promote China's commercial bank subordinated debt issuance can not only meet the requirements of capital, but also to improve the structure of assets and liabilities.

Keywords

Commercial bank, subordinated debt, risk management.

1. Introduction

On December 9, 2003, China's Banking Regulatory Commission issued the "Notice on Including Subordinated Periodic Debt in Supplementary Capital", which indicates that subordinated bonds have officially belonged to the category of subsidiary capital of China's commercial banks, also provide a good platform for a better development of China's financial market. "The Basel III" requires that commercial banks must have a capital adequacy ratio of at least 8%. The capital adequacy ratio of all commercial banks in the world has risen from 4% to 6% by the beginning of 2015. In 2013, China issued the "Administrative Measures for the Capital Management of Commercial Banks (Trial)", requiring that the capital adequacy ratio of systemically important banks in normal period should be greater than 11.5% before 2018, and the capital adequacy ratio of non-systematic banks must be greater than 10.5%. Thus, subordinated debt could be considered playing an increasingly important role in the development of China's subordinated debt market as an emerging financial instrument. After global financial crisis mainly represented by US subordinated debt in 2007, public has a more profound concept of financial security. Financial security has also become a new historical proposition. Therefore, sound laws, regulations and social supervision are needed to force financial supervisory authorities to make more stringent supervision. Therefore, commercial banks must consider the impact of various risk factors.

2. Status of State-Owned Commercial Bank Subordinated Bonds Issuance

Judging from the total issuance amount, in 2016 China's state-owned commercial banks issued 51.3% of the total issuance, joint-stock commercial banks accounted for 40.3% and city commercial banks accounted for 2.2%. According to "Administration of Issuance of Subordinated Bonds by Commercial Banks in China" that the core capital adequacy ratio of commercial banks should have met at least 5% and this has been achieved by the end of 2016, which indicates China's commercial banks have made full use of subordinated bonds to broaden the financing channels.

Due to subordinated bonds are unsecured, the issuance volume mainly depends on their capital strength and credit level; large companies can withstand the increase in the financial costs of issuing large amounts of bonds, and the better the credit level, the more adequate their capital needs. From the perspective of supply and demand, state-owned commercial banks are strong and easier to get the preference of investors. In addition, those commercial banks do not only meet the requirements for capital adequacy, but also realize their demand for large amounts of funds.

2.1 Status of Foreign Commercial Bank Subordinated Bonds Issuance

According to data statistics, the number of subordinated bonds issued by Europe's largest bank accounted for 73% of the total issuance volume and 84% of the amount, the ratio of subordinated bond balances and risk-weighted assets also reached 5.2%, those were issued twice a year on average and most of them were non-redeemable. The issuance of subordinated bonds mostly uses fixed interest rate with 10-year period, and the size is about 2.4 billion US dollars on average. The average time limit for issuance and the number of issuance have increased year by year, the proportion of long-term permanent subordinated debt has also increased. Bank of International Settlements made a statistical summary for each European country's subordinated bond and the results is shown in the table below:

Table 1 Subordinated bond issuance statistics

Country	Subordinated debt balance(equity)	Subordinated debt balance/risk-weighted assets	Average period	The proportion of the period of more than 5 years	Percentage of permanent subprime debt
Belgium	73.10%	9%	9.1	86.70%	16.20%
France	89.20%	n.a	10.8	100%	4.90%
Germany	55.20%	3.50%	9.5	98.70%	--
Netherlands	83.90%	5.30%	11	97.40%	7.70%
Spain	24.60%	n.a	11.7	99.40%	3.90%
Sweden	43.70%	5.70%	10.7	100%	15%
United Kingdom	n.a	n.a	14	98.20%	40.90%

Data Sources: Bank for International Settlements Working Paper

United States has also paid more attention to the prevention and control of subordinated bond risks in recent years with the changes in the entire financial environment. They also added some restrictive provisions with stricter issuance requirements and interest rates.

3 Comparison of Subordinated Bonds Issuance Between China and Foreign Commercial Bank

3.1 Comparison on Issuance Purpose

The capital attribute of subordinated bonds determines that its issuance purpose is a supplementary of capital, however more and more commercial banks consider subordinated bonds issuance as a channel for raising long-term capital, thus to improve the structure of assets and liabilities, minimize the possibility of liquidity risk. Banks in China issued subordinated bonds frequently in recent years, but they focused on the role in supplementing bank capital of subordinated debts, while neglecting the positive role of subordinated debts in bank asset liability management.

3.2 Comparison on the Way of Raising

Foreign subordinated bonds are mainly raised through public, public issuances is as high as 69% according to the issuance quantity, the proportion of reaches 80% in Sweden, Switzerland and the United Kingdom. In the United States and the Netherlands, they are all taken from the public. In 2003, China's Banking Regulatory Commission promulgated regulations requiring that subordinated bonds

must be raised from corporate legal persons other than banks. Therefore, China's commercial banks issued subordinated bonds privately in the initial period, followed by a regulation that banks could issue or raise funds among themselves and this has broadened the channels for the issuance of subordinated bonds. Therefore, the subordinated bonds of commercial banks in China will also be mainly issued through public now.

3.3 Comparison on Subordinated Bond Holders

Non-banking financial institutions hold relatively high amount of subordinated debt among foreign investing institutions, because non-banking financial institutions have large amount of assets in developed countries. The main investors of subordinated debt in China are mainly the insurance companies and commercial banks currently. The "Notice on Including Subordinated Periodic Debts in Supplementary Capital" stipulates that the issuance targets for bank subordinated debts is "to raise funds from corporate entities other than banks". After that, the targets of the issued subordinated bonds are mainly insurance companies.

3.4 Comparison on Credit Rating

The pricing of subordinated debt is affected by the reputation of the issuing bank in the international market, the better the reputation, the less the difference between the issuance pricing and the normal debt. In view of the current situation in China, the credit rating system is relatively backward. Even some foreign institutions have recently made credit ratings publicly on some banks in China, it is difficult to become the pricing basis for issuing subordinated debts in China.

4. Risks in Subordinated Bond Market of China's Commercial Bank

4.1 Liquidity Risk

The payment order of subordinated bonds is behind the general bonds; therefore, its issuance rate is higher than the average deposit rate. If the bank concentrates on solving the problem of capital insufficiency and does not manage risks and improve its own profitability and financial status, the banks will be then subject to larger financial pressure, which will weaken profitability. As shown in Table 4-1, the coupon rate of commercial bank subordinated bonds is generally higher than that of the corresponding 5-year bank deposits rates, as the credit rating declines, the difference is increasing, indicating that the banks experience higher Financing costs.

Table 2 Commercial bank coupon rate

	Spread (mean)					
	AAA	AA+	AA-	A+	A	BBB+
State-owned Commercial Banks	0.21	-	-	-	-	-
Joint-stock commercial bank	0.4	0.308	-	-	-	-
city Commercial Bank	-	0.8	1.04	0.69	1.63	1.8
Others	-	-	-	1.4	-	-

Source: China Bond Net, Annual Reports of Banks

4.2 Policy Risks

With the increasing size of subordinated debt issued by commercial banks, the scale of mutual holdings between banks has also risen, which has increased systemic risks since 2009, this caught the attention of the China Banking Regulatory Commission. As a result, China Banking Regulatory Commission issued the "Notice on Perfecting the Capital Supplementary Mechanism of Commercial Banks" on August 25, 2009 and October 21, 2009 (draft for solicitation of comments). And "Notice on Commercial Banks' Capital Supplementary Mechanisms." to strengthen regulation and promote the issuance of subordinated bonds by commercial banks.

4.3 Systematical Risks

At present, with the increase in the issuance size of subordinated bonds in commercial banks in China, it is common for commercial banks to hold subordinated bonds with each other. According to regulatory requirements, banks hold subordinated bonds between each other is more than 50%. According to the "Distribution Measures", the balance of subordinated bonds issued by other banks held by commercial banks must not exceed 20% of their core capital. However, the holding of subordinated bonds between commercial banks implies a huge risk. The mutual holding of subordinated bonds by commercial banks has increased the interdependence between banks. The repayment crisis of any bank will the chain to drive other banks into a crisis, which leads to systemic risks in the financial system.

5 Healthy Development Advice of Subordinated Debts for China's Commercial Bank

5.1 Regulate the Issuance of Subordinated Debts by Commercial Banks, Lower the Issuance Risks

Under the prevailing conditions in China, we must not only increase the capital adequacy ratio of banks, but also standardize the issuance of secondary banks, strictly review the issue entities, increase the development of credit rating laws and regulations, clarify responsibilities and rights, and make market more regulated. To reduce the risk of China's subordinated debt and strengthen the protection of investors' interests, it is necessary to combine the national conditions of China and the characteristics of China's financial market to carry out the following actions, such as the implementation of bond investors' free choice of a rating agency system and an increase in credit rating talent cultivation and so on.

5.2 Improve Information Disclosure, Rating System of Bonds and Issuer

In order to build a healthy and dynamic subordinated debt market, it is necessary to have a sound information disclosure and bond rating system. In particular, a timely disclosure of information about the possible fraudulent of a commercial bank is required, such as disclosure of information on capital structure and internal risk control reports. At the same time, a sound subordinated debt rating agency should be established to release clear market information and guide the subordinated debt market demand and transaction information.

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