

## **A Brief Analysis on Perpetual Bond Development in China**

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**Abstract:** Perpetual bonds are generally issued by non-financial institutions as issuers in the inter-bank bond market. It is originated in Britain and widely used in Europe and America. Since 2013, China has gradually opened up the perpetual bond market. However, as far as the current market is concerned, perpetual bonds are still innovative financial instruments and have many problems such as the accounting treatment. In order to explore the adaptability of perpetual bonds as a new financial instrument in China's financial market, this paper studies and analyzes the development mode of perpetual bonds according to the current situation and relevant policies of perpetual bonds at home and abroad. In China, perpetual bonds play an important role in improving the capital adequacy ratio of banks, the asset structure of enterprises and the investment structure of investors. However, there are still some risks such as unclear policies, insufficient issuance examination and low awareness of investors. In the future, we should moderately encourage the progress of perpetual bonds and make corresponding adjustments to the risks according to China's national conditions.

### **1. Introduction**

Perpetual bonds, usually issued by a listed company or a qualified bank, which does not have a maturity date or has a very long maturity (over 30 years) and the issuer may defer interest payments indefinitely. It has the characteristics of high coupon rate, long maturity, redemption clause of issuer, jump mechanism of interest rate and the combination of "debt" and "stock".

China's perpetual bonds started late. In 2013, Wuhan Metro issued "13 Subway Renewable Bonds", announcing the official entry of perpetual bonds into China's bond market. After 2015, the perpetual bond achieved rapid growth. By December, 2018, 1.75 trillion yuan of perpetual bonds had been issued. At present, there are about 1,174 perpetual bonds on the market, with a stock of 1.62 trillion yuan. Only in 2018, a total of more than 400 perpetual bonds were issued, issuance scale exceeding 540 billion yuan.

The main structure of China's perpetual bonds issuance is different from foreign countries. Issuers are mostly state-owned enterprises with extreme qualification ratings, especially the real estate and urban construction departments with large investment in a single project, while banks account for a relatively low proportion. Earlier this year, the central bank issued instrument swaps to help banks replenish capital. It will make the position of commercial banks in the perpetual bonds issuance increasingly obvious.

### **2. Risk analysis of China's future perpetual bond**

#### **2.1 The rules for the perpetual bond are unclear.**

In recent years, the scale of perpetual bonds is getting larger in China, but it is still a new capital tool for most investors. Perpetual bond in China's development is still a long way to be done. In addition, in terms of relevant policies and regulations, the provision on a perpetual bond still needs to be further clarified as follows:

#### **2.2 As for whether the interest on perpetual bonds can be repaid, there is no clear explanation.**

Due to the characteristics of both "Equity" and "Debt", it is controversial whether the interest on perpetual bonds can be deducted before tax. If the issuer determines that perpetual bond is equity

financing, then in terms of tax treatment, the interest on a perpetual bond is not allowed to be deducted before tax. If the issuer determines that perpetual bonds are bond financing, then in terms of tax treatment, the interest on perpetual bonds can be deducted before tax according to the provisions. At present, there is no relevant policy to clearly explain the interest payment of perpetual bonds. Enterprises should maintain the principle of consistency in tax treatment and accounting treatment, and not take advantage of both sides.

### **2.3 Pricing problems.**

with the coupon rate of foreign perpetual bonds, the pricing of Chinese perpetual bonds is lower and there are great differences among individuals. If perpetual bonds are used as equity financing, equity returns should be higher than bond yields. In addition, the duration of perpetual bonds is longer, and the yield on long-term bonds should be higher than that of short-term bonds. In addition, the discount rate reduces the actual value of the nominal fixed coupon payment. If the pricing of perpetual bonds is not high and the preferential policy of interest tax credit cannot be enjoyed, it will definitely affect the confidence of investors in perpetual bonds, which are not conducive to the development of perpetual bonds in the previous period. Therefore, it is necessary to standardize the pricing rules of medium - and long-term bonds as soon as possible to form a benign price market of perpetual bonds.

### **2.4 The issuance review of perpetual bonds is not strict enough.**

At present, each category of China's perpetual bond is regulated by different regulatory agencies, and there are some differences in the qualification requirements for issuers. Perpetual bonds, which are regulated by the National Association of Securities Dealers (NASD), are the most lenient. There are no debt rating requirements for issuing companies and no restrictions on profitability. The conditions for the issuance of perpetual bonds, which are regulated by the National Development and Reform Commission (NDRC), are the strictest. These differences in a certain extent caused by the quality of issuers intermingled. A recent example is AGILE, where perpetual bond is one of the main financing vehicles. According to the report for the first half of 2018, AGILE 's perpetual bond stood at 8.27 billion yuan, up 2.7 billion yuan from the end of 2017. The company's asset liability ratio was 38.2 percent, and its net asset liability ratio was 87.7 percent, up 16.3 percent year-on-year. AGILE needs to repay 2.26 billion yuan in the next year and 16.929 billion yuan in the next two to five years. A lot of data show that AGILE's financial situation is not optimistic. Coupled with the fact that AGILE did not meet the sales target set this year, AGILE will face great repayment pressure in the future, and may not be able to pay on time. The risk of real estate perpetual bond is very high. As perpetual bond is the last one among all liabilities of real estate developers to be paid off, once the company runs badly, the bank will face great risks. The asset liability ratio of real estate companies is generally high, and the one-time investment amount is large, and the capital turnover is slow. These are the main reasons for the real estate industry to favor perpetual bond, and also the reason for the greater risk of perpetual bond. Due to the long span of perpetual bonds, the regulatory authorities need to carry out a regular assessment for a long time in reviewing the issuance conditions of listed companies. When the company is in poor management, the company needs to be promptly downgraded. The evaluation requirements should also be more rigorous and detailed. The credit rating of each company should be made, profitability should be required, and the conditions should be differentiated and adjusted according to the characteristics of each industry. For example, for the real estate industry, a higher interest rate can be set to return the money to the failed enterprise as soon as possible.

### **2.5 Adhere to the principle of moderation.**

As investors, fat interest income is their biggest attraction. In pursuit of high profits, some private investors are too eager for quick results and investment in perpetual bonds just like ordinary bonds. This method is not advisable. We should grasp the comfort level of investment structure and reasonably allocate the proportion of various investment products. Most companies issuing perpetual bonds generally have better qualifications at the initial stage of issuance. Therefore, this

requires investors to accede to the principle of prudence, and choose companies with better qualifications and less impact from the macro economy. As issuers, we should also stick to the principle of moderation and prudence. Although perpetual bonds can raise large funds for the company without increasing the debt ratio, they may bring huge repayment pressure in the later period of renewal. A typical example is that on May 23, 2017, CRA downgraded the credit rating of IndusInd Bank from A to BBB- due to its failure to pay interest on time after it issued a large amount of ATI perpetual bonds. As a result, the asset quality of IndusInd Bank deteriorated sharply and increased the credit cost. In 2017, financial statements of IndusInd Bank showed a pre-tax loss of 86.186 billion rupees, forcing it to adjust the financing strategy. Although the current circular issued by the Central Bank and the China Banking Regulatory Commission greatly encourages qualified commercial Banks and companies to issue perpetual bonds to supplement capital and financing, in practice, it is necessary to analyze the current capital structure and solvency of the company from all aspects and reasonably arrange the issuance plan.

### **3. China's main measures are to develop perpetual bonds**

#### **3.1 Broaden the range of issuers.**

At present, the status of China's commercial banks in the perpetual bond market is not prominent, which cannot play the positive role of perpetual bonds in the macro market. On January 24, 2019, the Central Bank announced the decision to create the Central Bank Bills Swap (CBS) in order to improve the liquidity of perpetual bonds and support banks' issuance of perpetual bonds to replenish capital. Dealers can swap the perpetual bonds issued by qualified banks for central bank bills from the Central Bank. This announcement is for banks to enter the perpetual debt market has brought good news. First, the Central Bank allows banks to issue perpetual bonds to replenish tier one capital. This is also a further new measure taken by the Central Bank to promote loose credit after several reserve and interest rate cuts under the constraint of the current insufficient stock market support and new rules on subprime debt. By filling the current capital gap with perpetual bond, banks will have more money to lend. At the same time, supporting credit investment and corresponding measures, let the money flow into private enterprises, small and micro enterprises, stimulate the development of the real economy. Second, the Central Bank's creation of CBS is a clear endorsement of a perpetual bond. Perpetual bonds can be exchanged for central bills. This allows investors who were previously put off by the risk of an indefinite period to look again. Meanwhile, the China Banking Regulatory Commission followed the Central Bank's lead in announcing that it would allow insurance institutions to invest in qualified secondary capital bonds and open-ended bond. The move is intended to encourage insurers to buy perpetual bond. The combination of the China Banking Regulatory Commission and the Central Bank has greatly increased the attractiveness of the bonds, dispelled concerns and increased the appetite to purchase them.

Encourage more listed companies to enter the perpetual bond market. At present, Chinese banks participation in the perpetual bond market is not high, and the industry is not widely distributed, mainly focusing on the real estate industry, transportation and public construction. On the one hand, successful cases of the enterprises that have issued perpetual bonds are undoubtedly an important breakthrough in raising funds for bonds, which can mobilize the issuance willingness of other enterprises in the same industry. On the other hand, China should encourage the issuance of perpetual bonds suitable for the industry to finance in the future, which cannot only improve new financing channels for the company, but also reduce the refinancing cost. On the other hand, China should encourage the issuance of perpetual bonds suitable for the industry to finance in the future, which cannot only improve new financing channels for the company, but also reduce the refinancing cost. In addition, it can improve the familiarity of the public and institutions, which are conducive to long-term development of perpetual bonds. For some emerging industries, take green industry as an example, in order to cope with the pollution problem caused by current climate change and economic development, green enterprises generally need funds with a longer cycle to

support the development of green projects. For the high-tech industry, it usually takes a long time for a company to research and develop new technologies and equipment, and it needs a large and continuous capital source to support the product research and development and the subsequent supporting marketing and listing. Perpetual bond is a good choice for some new companies with appropriate qualification and credit. In addition, the current high asset liability ratio of power enterprises is limited by the fact that "the balance of accumulated bonds shall not exceed 40% of net assets", so the perpetual bonds provide a new financing direction without reducing the asset liability ratio.

### **3.2 Increase the scope and enthusiasm of investment entities.**

China's current promotion of perpetual bond development is mainly from the "seller's market", but the "buyer's market" is not strong initiative. On the one hand, this shows that whether the perpetual bond can be favored by investors still has great doubts, and investors are mostly in a wait-and-see state for the perpetual bond and lack of confidence. On the other hand, the current investors are mainly commercial banks and insurance institutions. Undertake insurance cost income is sluggish, future demand space is in doubt. In addition, there is little demand for long-term products, such as wealth management and funds. Therefore, breaking through the small demand group should be the focus of perpetual bond development in the future. Looking at trends in other Asian countries, retail customers, such as private banks, are the main drivers of demand. If we want to attract more investors in the future, we should standardize the credit rating system for the issuance of perpetual bonds; second and increase the coupon compensation. Experience in overseas markets suggests that perpetual bond redemption yields twice as much as regular bonds. In order to overcome the domestic investors' concerns about the long maturity and poor liquidity of perpetual bonds, a higher floating rate of the coupon should be given to them after they enter the redemption period.

### **3.3 It is conducive to improving China's capital market.**

Currently, China's bond market is developing rapidly. By the end of 2018, the balance of the bond market has reached 83.8 trillion yuan. The issuance of perpetual bonds is beneficial to supplement the current vacancy of medium and long-term bonds in China and promote the balanced development of multi-level capital market. At the same time, it also provides investors with a new type of bond investment tool with a long-term high coupon rate, so as to meet the diversified investment needs of investors, optimize the investment structure and fill the current market vacancy. At present, judging from the announcements issued by the Central Bank and regulators, China hopes to improve the capital market structure by promoting the issuance of perpetual bonds. And the current perpetual bond in the international market has become a mature bond financing products. In recent years, the speed of perpetual bond development has been accelerated and a relatively complete system has been formed in the European and American markets but in the ascendant in Asia. China encourages the development of long-term bond financing products, which are beneficial to supplement the vacancy of China's bond market, make it better in line with the international capital market, and accelerate the pace of the globalization of China's capital market.

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