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CSRC's Issued Trial Regulations on Exchangeable Bonds to Ease Selling Pressures

The China Securities Regulatory Commission issued trial regulations governing issuance of exchangeable bonds, effective from Oct 19. The new rule permits major shareholders of listed firms, rather than listed firms, to issue exchange bonds to the public by putting their tradable shares as pledges. To be able to issue exchangeable shares, an issuer has to qualify the following criteria:

- **The qualified issuer should have an equity value of at least RMB300 million.**
- **Average profit available for distribution during the recent three years should be no less than the interest payments of an exchangeable bond.**
- **Total bond balance after exchangeable bonds issuance should be no higher than 40% of equity value.**
- **The bonds should have a term from one to six years and have a face value of CNY 100, and can be swapped for shares of listed companies until 12 months after issuance ending day. Bondholders have the options to swap or not.**
- **The bonds can be redeemed by issuers or sold back to issuers with ex ante stipulation.**
- **The exchangeable price should be no lower than the average price of 20 trading days before the release of the prospectus, or the average price of previous closing day, whichever is higher.**

The new approach may be regarded as an attempt to solve heavy selling of nontradable shares by large shareholders recently, which could be one of important reasons for the continuous fall in Chinese stock market.

Also, the regulation offers a new perspective for M&As by issuing bonds directly to potential acquirers, or the acquirers can easily collect the bonds in market and swap to shares at specified time.

Is exchangeable bonds policy effective?

Policy may be effective if massive selling in stock market is triggered by the lack of capital due to the tightening credit, the policy might possibly be effective to cool down the selling, since the capital-thirsty shareholders can get the money by issuing the bonds and need not to dump their holdings.

[1] Total unlocked shares have three sources: split-share reform, initial public offerings and seasoned equity offerings. Among the three, split-share reform is the largest source occupying 55% of total unlocked shares until September 17, 2008.

Policy may not be effective if the selling behavior is guided by major shareholders' investment philosophy that is driven by momentum, i.e., selling as market falls and buying as it rises, then the policy would not be effective as expected because the sale of the bond is not due to lack of money but due to trimming losses.

However, the policy has an inherent inconsistency because

- The policy has put the bond issuer into one inferior position. Simply put, if the shares are going down, the bond holders will have no incentive to swap; still, the bond issuer needs to pay the principal and interest, in addition to the loss of the share prices fall, worse than selling the shares in the first time. But when the price is up, they will face the situation to swap their shares with bond holders, and can't get the benefits of the price appreciation, the payoff almost equal to selling the shares in the first time.
- The benefit that the issuer could get from the exchangeable bonds is price gap between the exchangeable price and prevailing price when issuance. In addition, the interest payment of the bond should be less than the interest rate charged by banks.

Given the inferior position that major shareholders are facing, their incentive to issue exchangeable bonds might be less strong than expected. Payoff for issuing exchangeable bonds is less advantageous than selling in the market. Besides bond issuance follows a long and complex procedure, plus the underwriting fee is around 2%. The policy seems less attractive to the unlocked shareholders.

Despite these drawbacks, this is one of the latest measures the CSRC has taken to shore up the market, including a block trade system in the first half of the year and the planned secondary offerings and planned financing & securities lending scheme. It appears that none of them has worked so far.

The impact of non-tradable shares on China's stock market: A damacles' sword

The reasons for the stock market falling should be attributed to gloomy economic outlook, volatile global market, dumping from unlocked shares, etc. Even if unlocked shares issue is not the top one, it may exacerbate the situation once market falls.

Indeed, the true pressure comes more from the psychology, since minority shareholders don't know when shares will be dumped once they are unlocked, the only thing they can hedge the risk is to sell. Actual selling of unlocked shares from split-share reform is less than people thought; cumulative selling ended in August is 26.3 billion shares, 24.3% of cumulative unlocked shares, but the first batch of locked shares starts trading from June 2006, so the dispersed influence from then is even much less than a large IPO.

We find a negative lead-lag relation between number of total unlocked shares[1] and market return with one-month lag (Chart 1 and Table 2), but little relation between unlocked shares from split-share reform and market return. If we calculate the correlation from June 2006, it is -0.667; if we use recent data from Jan. 2007 when the unlocked shares start to increase or use the data from Oct 2007 when market is peaked, the correlations are even higher, respectively -0.741 and -0.743;

Chart 1 also presents the relation that a large number of unlocked shares in this month will depress stock return next month.

Table 1: Recent selling statistics of shares from split-share reform

Billion

Market	Month	Cum. selling	Monthly Selling	Cum. unlocked	Monthly unlocked	Cum. shares	Selling ratio
	June	16.3	0.3	62.8	2.2	338.3	26.0%
Shanghai	July	16.9	0.6	64.5	1.8	341.2	26.3%
	August	17.3	0.3	85.1	20.6	342.8	20.3%
	June	8.7	0.1	21.5	0.8	119.0	40.3%
Shenzhen	July	8.9	0.2	22.3	0.8	120.9	40.0%
	August	9.0	0.1	23.3	1.0	120.9	38.9%
	June	25.0	0.5	84.3	3.0	457.2	29.7%
Total	July	25.9	0.8	86.8	2.5	462.1	29.8%
	August	26.3	0.5	108.4	21.5	463.7	24.3%

Note: Cum. Selling means the cumulative number of shares sold from the locked shares start trading.

Monthly selling means the number of shares sold in the month.

Cum. Unlocked means the cumulative number of shares that have been unlocked.

Cum. Shares means total number of shares generated from split-share reform, equal unlocked plus still locked shares.

Selling ratio is calculated as cum. selling divided by cum. unlocked.

Table 2: correlation between unlocked shares and stock return with one month lag

	Stock return (from June 2006)	Stock return (from Jan 2007)	Monthly stock return (from Oct 2007)
Total unlocked shares	-0.667	-0.741	-0.743
Unlocked shares from split-share reform	-0.349	-0.359	-0.412

Note: both are monthly data.

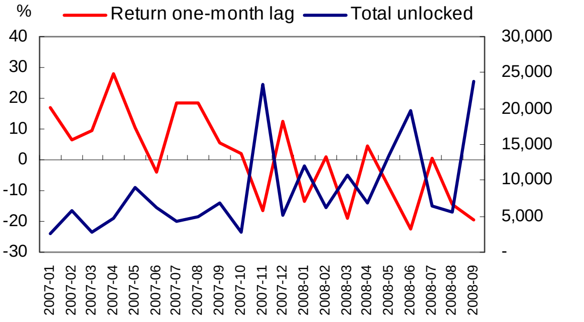
Chart 2 shows the trend of unlocked shares starts to accelerate recently, and split-share reform contributes to 55% of total unlocked shares. However, it is still much less if comparing to the peak season is in 2009 (Chart 3). If the authority doesn't solve the overhung problem and let the market finds its self-equilibrium, Chinese stock market might converge to a point where stock price equal to book value, i.e., PB ratio equal one, where it will get the same return to sell a stock or a company. Given PB ratio in Shanghai Stock Exchange is 2.52 in Oct 21, the extreme scenario would push Shanghai Composite index down lower than 1000 points. Of course this is the worst scenario, when the market continues going down, the government might buy the shares directly from the market to shore up.

Fortunately, Chinese government have taken series of measures to prop up the falling stock market since Sept 19, but in a long run, the unlocked shares issue still needs to be cured.

Thus, we suggest launching a buffer or stabilization fund specially used for the unlocked shares from split-share reforms. The average price per share is CNY 6.4 when Shanghai Composite Index is at 1900 points. Cumulative shares from split-share reform are 463.7 billion by end of August, and assuming selling ratio is around 30%, which is expected to be lower especially when large SOE shares are unlocked in the coming months. The stabilization fund can intervene when market falls to a specific level, assuming 1500 points of Shanghai Composite Index, the maximum fund needed is around RMB 700 billion, and the fund can sell the stakes when market is booming. The Investors Protection Fund already in existence can carry out such a mandate, and fund source either from fiscal transfer or lending from central bank.

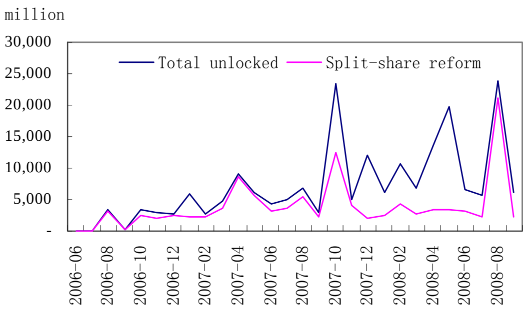
This measure would strengthen market confidence and effectively calm down irrational sharp fluctuation of stock market by reversal operation.

Chart 1: Negative relation between unlocked shares and monthly stock return with one-month lag



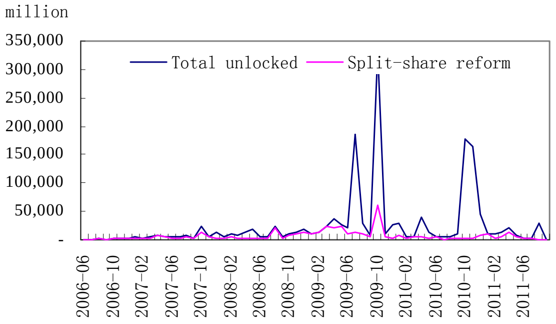
Source: Wind and BBVA research

Chart 2: Monthly total unlocked shares and unlocked shares from split-share reform until now



Source: Wind and BBVA research

Chart 3: Monthly total unlocked shares and unlocked shares from split-share reform until 2011



Source: Wind and BBVA research