

# Problems and Countermeasures Analyses of Market-oriented Debt-to-Equity Swaps in China

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**Abstract.** In 2016, for the sake of addressing the high leverage of non-financial enterprises and the persistently high number of non-performing loans in commercial banks, the State Council once again proposed market-oriented debt-to-equity swaps. This round of debt-to-equity swaps exhibits distinct characteristics of marketization and legalization and has played a significant role in improving the financial market environment, reducing corporate debt burdens, and achieving deleveraging goals. However, during the implementation process, there are still many practical problems that prevent the fundamental resolution of difficulties. This paper conducts an in-depth analysis of the issues related to market-oriented debt-to-equity swaps and proposes targeted suggestions to establish a more comprehensive institutional framework, aiming for a win-win cooperation among enterprises and banks.

**Keywords:** Marketization, debt-to-equity swap, implementation issues, implementation strategies.

## 1. Introduction

The global financial crisis in 2008 led to a global economic downturn, causing a downturn in financial markets and significantly impacting China's economy. In response, the government introduced a comprehensive pro-cyclical economic stimulus plan, primarily centered on a 4 trillion-yuan investment plan. The rapid expansion of loans led to a substantial increase in the debt-to-GDP ratio of the non-financial corporate sector in China, rising from 195% in 2017 to 317% by the end of 2014 [1]. The leverage ratio of China's non-financial industries increased rapidly, leading to significant macroeconomic pressure, with the leverage ratio of the non-financial corporate sector by the end of 2015 far exceeding that of other sectors, indicating persistent debt risks and non-systemic risks. To effectively deleverage and alleviate debt burdens, in 2016, the State Council issued policies such as the Opinions on Actively and Prudently Lowering Corporate Leverage Ratios and the Administrative Measures for Newly Established Debt-to-Equity Swap Implementation Institutions of Commercial Banks (Trial) to promote supply-side structural reforms based on principles of legalization and marketization. These policies guided the effective implementation of debt-to-equity swaps by institutions, reducing the non-performing loan ratio of banks and promoting win-win cooperation between enterprises and banks. Therefore, given the current external financial market environment, conducting an in-depth analysis of the shortcomings of the new round of market-oriented debt-to-equity swaps and proposing targeted suggestions is of great significance for improving current market-oriented debt-to-equity swap policies and promoting effective deleveraging efforts.

## 2. Problems in the Implementation of Market-oriented Debt-to-Equity Swaps

### 2.1. Difficulty for Debt-to-equity Swap Enterprises in Selection

Unlike the previous round of debt-to-equity swaps led by the government, the current round of debt-to-equity swaps allows banks to select target enterprises independently. While this increases investment flexibility, it also means that banks and other institutions need to bear greater risks. The conversion of collateral value from enterprises and regular bond yields to irregular equity dividends is the model for equity returns. Dividend amounts depend on profitability, which is influenced by various factors, leading to high volatility and poor stability. Most enterprises in need of debt-to-equity

swaps face financial difficulties and imbalanced debt structures, resulting in reduced profitability. After the transformation, their originally prioritized creditor's repayment rights are lost, potentially leaving banks facing situations where target enterprises may not distribute dividends for several years or may distribute dividends irregularly [2]. Therefore, commercial banks are required to comprehensively consider various factors and cautiously select target enterprises with promising development prospects or those experiencing temporary difficulties. Otherwise, decision-making errors could lead to significant financial risks. However, qualifying enterprises are few, and banks lack experience in investment decision-making, making it challenging to make accurate judgments. Any mistakes could lead to resource wastage, financial distress, and the inability of genuinely needy enterprises to obtain financing for survival, rendering the debt-to-equity swap policy meaningless [3].

## **2.2. Moral Risks in Debt-to-Equity Swaps**

The State Council's Guiding Opinions on Market-Oriented Bank Debt-to-Equity Swaps stipulates that the target enterprises for this round of debt-to-equity swaps are high-quality enterprises with good development prospects but temporary difficulties. The swap is prohibited for zombie enterprises, malicious debt evasion enterprises, and enterprises with complex creditor-debtor relationships [4]. However, due to asymmetric information between banks and enterprises, banks cannot fundamentally understand the debt and profitability situation of enterprises. Additionally, the evaluation system for target enterprises in debt-to-equity swaps is still imperfect, leading to decision-making errors by banks. Selected enterprises can transfer their debts through debt-to-equity swaps to alleviate their debt burdens. Local governments, focused on regional development, recommend some economically challenged enterprises to banks for debt-to-equity swaps. Once these problematic enterprises gain control, they may intentionally default on debts through illegal means, attempting to secure further bank support to salvage their operations. Faced with this "default mechanism," banks, to avoid greater losses from bankruptcy liquidation of enterprises, are compelled to continue lending to these enterprises, leading to a vicious cycle and further increasing banking risks [3]. Coerced by defaulting behaviors, banks are unable to allocate resources rationally, denying well-deserving opportunities for genuinely distressed yet quality enterprises, which prolong their survival difficulties. In case of bankruptcy liquidation of target enterprises, commercial banks face significant financial losses, and quality enterprises are affected by moral risks, making their survival challenging.

## **2.3. Imperfect Entry Mechanism for Debt-to-Equity Swaps**

Bank-initiated debt-to-equity swaps do not entail long-term holding of company equities as they aim to recover initial investment funds. Generally, banks exit when a company's operating conditions improve, and profitability strengthens. The current market-oriented debt-to-equity swaps provide various equity exit channels such as stock repurchase, stock transfer, and stock listing. However, due to poor liquidity in China's financial markets and lack of centralized trading platforms, the "raising stocks and exiting stocks" cycle cannot form a closed loop, hindering equity exits in the short term and increasing banks' investment risks [5]. Moreover, due to poor profitability, most enterprises prefer stock repurchases. However, most debt-to-equity swap enterprises are crucial forces within group companies. Uncertainty exists regarding their ability to repurchase without achieving profitability goals [6]. Additionally, repurchases require shareholder meetings for resolutions, and conversion institutions are often controlled by minority shareholders, raising uncertainties about decision-making constraints. Thus, due to exit difficulties, the risk premium for equity post-debt transfer increases, leading to higher transaction costs.

## **2.4. Inadequate Legal Regulations for Debt-to-Equity Swaps**

Article 43 of the Commercial Bank Law stipulates that commercial banks within the People's Republic of China are prohibited from engaging in trust investment and securities business, investing in non-self-used real estate, or investing in non-banking financial institutions and enterprises, except as otherwise provided by the state. Although policies related to debt-to-equity swaps have been

introduced, they conflict with existing legal regulations in some areas, lacking safeguards where disputes arise. Until new legal regulations are enacted to adapt to the new environment, these restrictions limit the smooth implementation of debt-to-equity swaps [2]. Additionally, some legal regulations that favor the implementation of debt-to-equity swaps in China are still imperfect. On one hand, if laws are not explicitly stated, some commercial banks adopt a cautious attitude, reducing investment risks but also missing out on good investment opportunities. On the other hand, broad regulations make it easy for enterprises or commercial banks to engage in manipulative behavior and abuse debt-to-equity swap policies for profit [7].

### **3. Advancing Market-Oriented Debt-to-Equity Swap Strategy Further**

#### **3.1. Clarifying Standards for Selecting Debt-to-Equity Swap Enterprises**

It is a prerequisite for the effective progression of subsequent work to autonomously select debt-to-equity swap enterprises according to certain standards [8]. Firstly, commercial banks need to clarify internal financial conditions, management models, profitability, product quality, production standards, etc., and assess the current status and development prospects of enterprises. Secondly, it is necessary to choose growing enterprises with good development prospects and profitability for funding [9]. For example, emerging technology industries that contribute to optimizing China's industrial structure not only alleviate financial burdens but also optimize the industrial structure and enhance market activity, allowing banks to reduce leverage and non-performing loans. Lastly, it is crucial to avoid selecting problematic enterprises with illegal activities or no development prospects to reduce investment risks.

#### **3.2. Improving Equity Exit Mechanisms**

China should further improve its financial markets by fully utilizing the Growth Enterprise Market (GEM), the New Third Board, the Small and Medium Enterprise (SME) Board, regional equity trading centers, or establishing a dedicated debt-to-equity swap asset trading market or sector. This would invigorate non-performing asset markets, expand platforms for non-listed company equity transfers, and diversify exit channels to complete the "raising stocks and exiting stocks" loop [2]. Banks can choose appropriate equity exit mechanisms according to their characteristics to resolve concerns during debt-to-equity swap implementations and promote continuous business expansion. Simultaneously, leveraging traditional exit methods like equity repurchases and mergers and acquisitions (M&A) would effectively restructure social resources, facilitate capital flow efficiency among resources, form more comprehensive and competitive enterprises, increase profit potential, attract social capital infusion, reduce capital recovery periods, and enhance capital utilization rates [6].

#### **3.3. Enhancing Implementation Agency Capabilities**

Implementation agencies are key entities in market-oriented debt-to-equity swaps and must effectively enhance investment and coordination capabilities to ensure efficient implementation. Firstly, enhancing investment capabilities can be achieved by altering equity forms such as converting common stock into preferred stock. Preferred stock improves capital injection efficiency, protects commercial banks' priority repayment rights, avoids corporate control dilution, and safeguards interests of enterprises and banks, thereby reducing investment and financing risks [5]. Secondly, enhancing personnel structures, establishing specialized analysis and evaluation teams, analyzing enterprise financial conditions in the early stages, coordinating funds mid-term, promoting project progress, and effectively recapturing funds by identifying suitable equity exit channels in the later stages. Lastly, improving regulatory assessment mechanisms, formulating risk mitigation measures, investigating credit record performance, strictly penalizing illegal actions like defaulting on debts to reduce debt-to-equity swap risks, and ensure effective project advancements [4].

### 3.4. Enhancing Relevant Legal Regulations

Sound legal regulations are prerequisites for the effective implementation of debt-to-equity swaps. China should intensify efforts to perfect debt-to-equity swap legal regulations, determine implementation standards, and provide guarantees for market-oriented debt-to-equity swap implementations. Firstly, the government should formulate specialized laws and regulations tailored to the characteristics of the new round of debt-to-equity swaps, clarifying applicable scopes, responsibilities of all parties, evaluation criteria, implementation mechanisms, etc., to provide legal guidance for all participating entities [10]. Secondly, amendments and supplementary explanations should be made to existing regulations such as the Commercial Bank Law, Guarantee Law, Company Law, etc., to reduce restrictions during debt-to-equity swap implementations, harmonize new and old laws, safeguard the rights and interests of all parties, and reduce implementation risks [7]. Simultaneously, promoting oversight among all parties, specifying penalties for dishonesty and illegal behaviors, and maintaining a conducive market environment for debt-to-equity swaps are essential.

## 4. Conclusion

The recent round of market-oriented debt-to-equity swaps has demonstrated distinct features of marketization and legalization. However, prominent issues currently faced include a lack of clear regulatory selection mechanisms, difficulties for implementing agencies in accurately screening and positioning target companies in need of assistance, limited channels for financial market exits after debt-to-equity swaps, conflicts of interest between enterprises and banks leading to cooperation moral risks, and incomplete legal regulations resulting in obstacles to the smooth progress of debt-to-equity swaps. The successful implementation of market-oriented debt-to-equity swaps requires correct guidance from the government and concerted efforts from enterprises and implementation agencies. The government should expedite adjustments to relevant laws and regulations, provide directional guidance and implementation restrictions to banks and enterprises; banks should leverage debt-to-equity swap opportunities to help enterprises reduce leverage, improve regulatory mechanisms, incorporate corporate governance, promote sound corporate development, and jointly create favorable equity exit mechanisms; companies should enhance integrity, actively reduce debts, drive innovation, refine business models, promote industrial structural development, and reduce investment risks in debt-to-equity swaps. Through tripartite cooperation, a diversified and mutually beneficial market-oriented debt-to-equity swap environment can be created.

This article's analysis of debt-to-equity swap issues still has shortcomings, such as not addressing issues like equity-for-debt swaps and debt-to-equity swap pricing. Although practical suggestions have been proposed for the new round of debt-to-equity swaps, the complexity, multifaceted nature of debt-to-equity swap problems, and limitations of individual perspectives inevitably lead to less thorough analysis. This reflects the need for deeper and more specific analyses in line with the current market environment. It also provides directions for improvement and refinement for future research to comprehensively address market-oriented debt-to-equity swap issues.

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