ICRA

Indian Banking Sector
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Equity Capital requirements for banks could increase as risk aversion for AT-I bonds likely to go up

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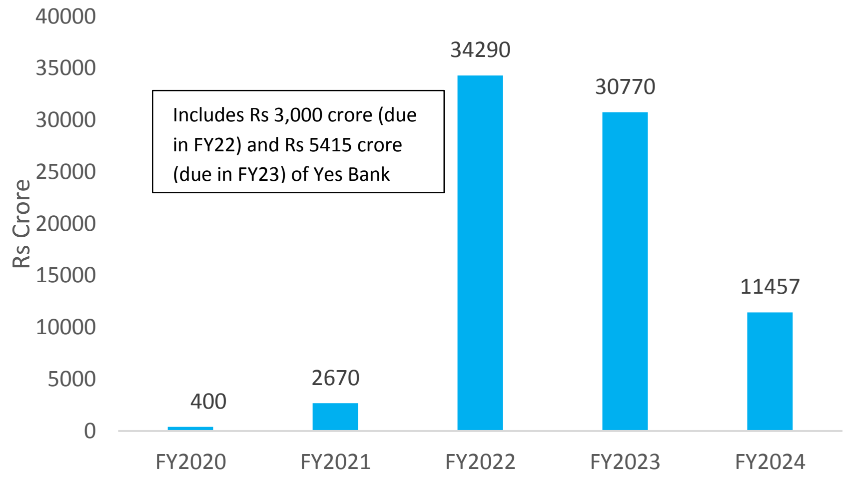
Highlights

- ***The proposed write-down of the Additional Tier – I (AT-I) bond as a part of the restructuring plan of Yes Bank Limited is likely to further increase the risk aversion of the investors as the investors will factor in a higher probability of write-downs on these bonds.***
- ***Investors' appetite for future issuances of AT-I bonds to reduce. Further investor base to also likely reduce as the recent event may prompt certain some of them to avoid these bonds in future.***
- ***As per ICRA's estimates, a total of Rs 93,669 crore of AT-I bonds will be outstanding as on date (Rs 84,574 excluding Yes Bank), of which Rs 39,315 crore will be of private banks (Rs 30,620 crore excluding Yes Bank).***
- ***Most of these bonds were issued during FY2017 and FY2018 with first call option after 5th year from issuance and hence large bonds are due for call in FY2022 and FY2023.***
- ***Amid the risks emerged from the recent event, ICRA expects, the Investors' appetite for future issuances of AT-I bonds to reduce, thereby constraining banks from rolling over these bonds by exercising call option and fresh issuance***

EXHIBIT 1: Yearly call option on AT-I bond of PSBs and private banks



Source: Banks, ICRA research. Data for the bonds outstanding as on March 6, 2020l. Above data assumes the call option in 5th year from issuance, though few issues had a call option in 10th year.

- ***Given the expected increase in risk premium for these bonds, the banks have incentives to not exercise the call option, given the lucrative rates at which the past issuances (see exhibit 5). However, a decision to not exercise a call option may have an investor back-lash who have invested in these bonds from 5-year perspective and impact their future fund-raising activities.***
- ***Capital cushions over regulatory levels to decline by an estimated 1% of risk weighted assets (RWAs) in case they are unable to replace them with fresh issuances or AT1 issuances.***
- ***Under large exposure framework, the exposure to single borrower or group of borrowers is linked to Tier-I capital, and reduction in Tier-I capital upon redemption of these bonds will also reduce ability of the banks to take large exposures to a borrower group***

Rollover by PSBs during FY2022 to indicate the investor's appetite for these bonds

EXHIBIT 2: Year-wise call option on AT-1 bonds of public sector banks

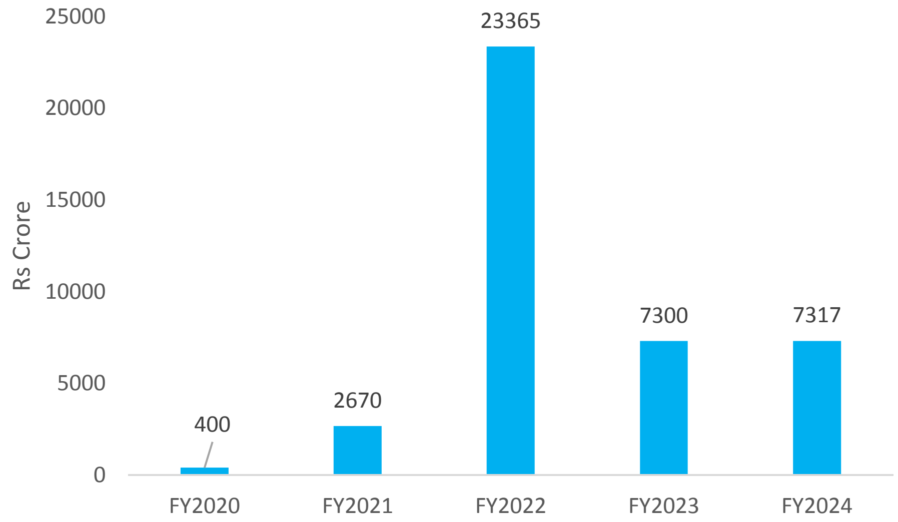
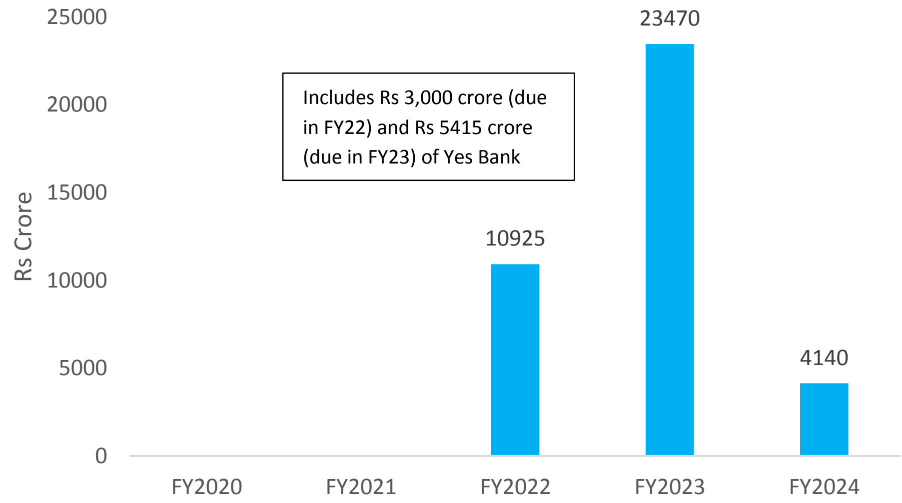


EXHIBIT 3: Year-wise call option on AT-1 bonds of private sector banks



Source: Banks, ICRA research. Data for the bonds outstanding as on April 1, 2020. Above data assumes the call option in 5th year from issuance, though few issues had a call option in 10th year

Key features of the Basel III compliant AT-I bonds

- There is no put option available with the investors and if the bank can decide to not exercise a call option before 5th year, after which the call option is due annually. Moreover, any call option exercise exercised by the bank is subject to an approval from the regulatory, i.e. Reserve Bank of India (RBI).
- A bank cannot exercise a call option unless, a) the bond is replaced with same (another AT-I) or a better quality (Core equity or CET-I) capital; or b) the bank maintains capital ratios above regulatory levels (including capital conservation buffers – CCBs), i.e. CET-I of 8.0% and CRAR of 11.5%.
- Coupon payments are non-cumulative and discretionary, and the bank has the full discretion at all times to cancel coupon payments. Cancellation of discretionary payments shall not be an event of default and hence does not triggers any cross-default on other borrowings. Coupon once skipped is non-cumulative.

- Coupons can be paid out of the current year profits. However, if the current year's profit is not sufficient, or, if the payment of coupon is likely to result in a loss, the coupon payment can be done through reserves and surpluses subject to the bank meeting the minimum regulatory requirements for CET I, Tier I and total capital ratios (including capital conservation buffer, CCB)

- These at-I bonds are expected to absorb losses through the write-down mechanism at the objective pre-specified trigger point fixed at the bank's (CET-I) ratio as prescribed by the RBI – 5.5% till March 2020, and thereafter 6.125% of the total risk weighted assets (RWA) of the bank or when the Point of Non-Viability trigger is breached in the RBI's opinion

- The claim of AT-I bondholders shall be a) superior to equity shareholders and preference shareholders, b) subordinated to claims of depositors and creditors, however the recent instance shows that this clause is not applicable practically as these bonds could face the loss much before liquidation.

Basel II Hybrid Instruments:

Under the Basel II regime, Banks issued following three debt capital instruments, the risks for which are as under:

1) Basel II Lower Tier I – Coupon payment is not contingent on profitability or capital ratio of the bank
2) Basel II Upper Tier II – Coupon payment is contingent on profitability as well as CRAR of 9.0%. In case breach of CRAR, the coupon is not payable; additionally, if the bank makes loss, it needs prior approval of RBI for coupon payment, provided the CRAR remains above 9.0% upon payment of coupon. Call option can be exercised with prior approval of RBI. Coupon if not paid, is cumulative.
3) Basel II Tier I – Same as Basel II Upper Tier II, but coupon is non-cumulative.

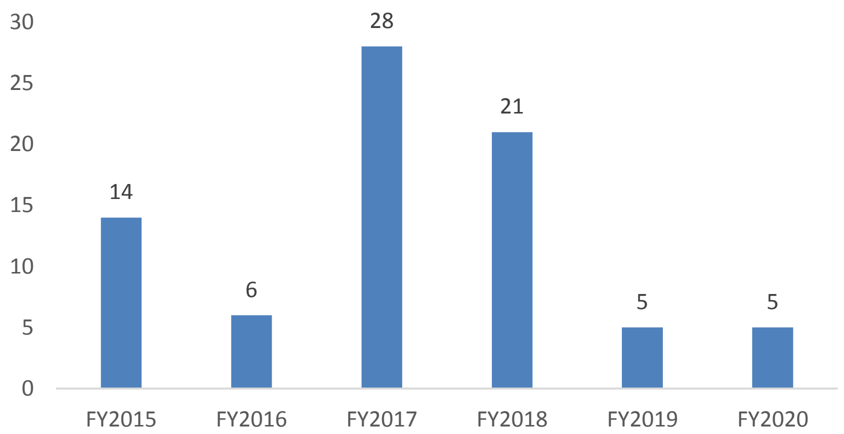
None of the Basel II instruments is subject to a write down clause.

Given the above features, ICRA has been notching down the ratings of Upper Tier II and Basel II Tier I bonds from the base rating (Basel II Lower Tier I). Recently, Yes Bank had a coupon payment on its Basel II Upper Tier I bond on March 5, 2020, for which it didn't received RBI approval as it reported losses during H1FY2020 and in absence of its Q3FY2020 financials, the capital position was not certain.

Earlier in August 2016, another private bank, i.e. Dhanlaxmi Bank defaulted on coupon payments on its Upper Tier II bonds as it reported CRAR below 9.0%

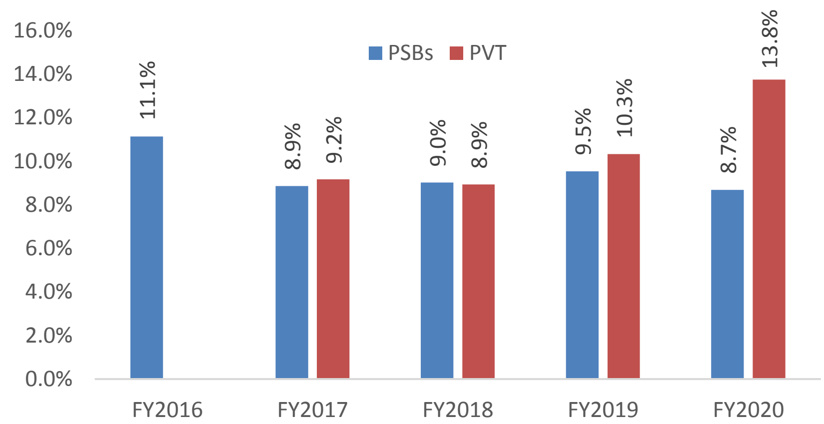
Investors should consider the risks inherent in the debt capital instruments of the banks as highlighted above.

EXHIBIT4: No of AT-I bond issues picked up in FY2017 and FY2018



Source Banks, ICRA research. Includes the bonds issued by PSBs, which were subsequently included in PCA and they recalled these AT-1s prior to scheduled call option date

Exhibit 5: Value -weighted average coupon of the AT-1 bonds issued



Source Banks, ICRA research. Excludes the bonds issued by PSBs, which were subsequently included in PCA and they recalled these AT-1s prior to scheduled call option date

- Relaxation in criterion of coupon payment by RBI during February 2017 also improved the investor appetite for these bonds and the probability of coupon skip on these bonds reduced.
- Decline in bond yields after demonetization and increasing capital requirements of the banks spurred up the bond issuances during FY2017 and FY2018 (as reflected in the first call option after 5 years is falling due on the stock of these bonds in FY2022 and FY2023 (exhibit 2 and 3).
- Given the recent development on a likely complete loss of investment, the risk premium of 2-3% over the risk-free rate for such bonds in the past could increase for future issuance

Summary of features of debt capital instruments

Instrument	Risk of Coupon Skip	When is Coupon Skipped?	Risk of Write Down/ Conversion into CET1	When is the Instrument Written Down?	Rating
Basel II Lower Tier II	No	-	No	-	Base rating
Basel II Upper Tier II	Yes	In case bank breaches CRAR. Coupon, if not paid, is cumulative	No	-	Notched down rating
Basel II Lower Tier I	Yes	In case bank breaches CRAR. Coupon, if not paid, is non-cumulative	No	-	Notched down rating
Basel III Tier II	Yes	Invocation of PONV	Yes	At PoNV	Base rating; however, may be notched down if likelihood of PoNV becomes high
Basel III AT-I	Yes	In case bank breaches (CET1 or Tier I or CRAR including CCB/CCCB) or it incurs losses and does not have sufficient distributable reserves to service the coupon. Coupon, if not paid, is non-cumulative.	Yes	AT CET1 < 5.5% of RWA (until March 2020 and 6.125% of RWA thereafter) at the option of the RBI	Notched down rating

Source: ICRA research

Related ICRA Articles on AT1 instruments

1. Indian Banking Sector: Investors in Additional Tier I bonds should be mindful of possibility of coupon skip – October 2017
2. Indian Banking Sector: Risk of coupon skip subsides as weak PSBs initiate early recall of their AT-I bonds – February 2018
3. ICRA's bank rating methodology – February 2018

RBI Circulars

1. RBI Circular modifying the terms and conditions for coupon payment on AT-I – September 2014
2. RBI Circular modifying the terms and conditions for coupon payment on AT-I – February 2017

Annexure 1: Bank-wise call option on AT-1 bonds outstanding as on April 1, 2020

	FY2020	FY2021	FY2022	FY2023	FY2024	FY2025	Total
Andhra		800	900	500	0	0	2200
BoB	400	500	2325	1350	0	3397	7147
Canara		0	1000	0	0	1500	2500
Indian		500	0	0	0	0	500
PNB		0	2250	1500	0	1500	5250
P&SB		0	0	1000	0	0	1000
Syndicate		870	1930	450	0	0	3250
Union		0	3750	500	0	0	4250
SBI		0	11210	2000	7317	6905	27432
Axis		0	3500	3500	0	0	7000
HDFC		0	0	8000	0	0	8000
ICICI		0	3425	5555	1140	0	10120
IndusInd		0	1000	1000	2000	0	4000
J and K		0	0	0	1000	0	1000
SIB		0	0	0	0	500	500
Yes		0	3000	5415	0	280	8695
	400	2670	34290	30770	11457	14082	93669

Source: Banks, ICRA research. Data for the bonds outstanding as on March 6, 2020. Above data assumes the call option in 5th year from issuance, though few issues had a call option in 10th year

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