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Dislocation of Additional Tier I market
could increase the bank recapitalisation
burden for the Government of India

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RAISING DEBT CAPITAL COULD BECOME A CHALLENGE FOR BANKS AS MUTUAL FUNDS ARE SIZEABLE INVESTORS IN THEIR BONDS

SEBI has issued directions to the mutual funds to limit their holdings in Basel III capital instruments issued by the banks

SEBI has also directed AMCs to value PDIs on the basis of 100-years of maturity, unlike the current practice of valuing these bonds on the basis of the call option date

Given the cap specified by SEBI, the headroom for incremental investments may be limited, which will reduce the appetite of mutual funds for fresh investment in the Basel III bonds of banks

BACKGROUND

The capital market regulator, the Securities and Exchange Board of India (SEBI), issued a [circular](#) on March 10, 2021, whereby it has revised the norms for investments by debt mutual funds in Basel III debt instruments issued by banks. The circular also mentions the revised norms for the valuation of perpetual bonds issued by various classes of issuers (banks, non-banking financial companies (NBFCs) and corporates). The key highlights of the circular are:

- No mutual fund across all its schemes to own more than 10% of all Basel III instrument issued by any bank
- No more than 10% of net asset value (NAV) of the debt portfolio of the scheme shall be invested in Basel III instruments
- No more than 5% of the NAV of the debt portfolio of the scheme shall be invested in Basel III instruments of a single issuer
- All existing holdings in Basel III instruments above the specified threshold may be grandfathered and no fresh investments to be made till the investments in such instruments come below the above-specified thresholds

In addition to investment limits, all schemes holding Basel III instruments shall necessarily have provisions for the segregation of the debt portfolio and such segregation is to be triggered when the instrument is written off or converted to equity.

Further, SEBI has changed the valuation norms for perpetual instruments issued by banks/NBFCs or corporates, whereby the maturity of all such instruments is to be taken as 100 years from the date of issuance.

The above directions will come into effect from April 1, 2021.

APPETITE OF MUTUAL FUNDS FOR BASEL III BONDS OF BANKS TO TAKE A HIT; FRESH ISSUANCES COULD BECOME A CHALLENGE EVEN AT HIGHER COSTS

In ICRA's view, the proposal to limit the composition of the Basel III bonds in the overall assets under management (AUM) is unlikely to pose challenges as the holding of Basel III Tier I and Tier II instruments is estimated at 8% of the AUM of the schemes in which these are held by the asset management companies (AMCs). However, some of the larger AMCs are closer to 10% of the NAV threshold limit for investments in these bonds, which could potentially impact the incremental demand for such bonds from these larger AMCs unless there is a steady growth in their AUM. As a result, this could reduce the appetite of mutual funds which are significantly large investors in the Tier I and Tier II bonds of banks.

Mutual funds are dominant investors in the bonds of the bank, with estimated holding of 30% of Tier I bonds outstanding and 14% of Tier II bonds outstanding as of February 2021

Reduced appetite for mutual funds would not only increase the issuance cost for issuers, but could possibly make it challenging for the issuers to raise the desired quantum of debt capital

Banks are the largest PDI issuers, with outstanding bond volumes restricted to a few large banks. The proposed valuation norms could trigger volatility in the AUM and corporate bond yields in the near term

Public banks have sizeable amount of AT-I bonds falling due for call option in FY2022, which will need to be replaced. As per ICRA's estimates, the capital budgeted by the GoI factors in the replacement of AT-I bonds in FY2022 by PSBs

As per ICRA's estimates based on the industry data, mutual funds hold 30% of the Tier I bonds outstanding and 14% of the Tier II bonds outstanding in February 2021 (refer Exhibit 1). As the incremental demand from mutual funds declines for the Tier I and Tier II bonds of banks, the issuance costs for the banks could rise making it costlier for the banks to raise debt capital. The yields have already seen an upward trend since the circular was issued with an increase in traded volumes reflecting the selling of these instruments.

With constraints on investment limits, the funds may even become more selective in taking fresh exposure, which could mean that certain banks, despite a higher issuance cost in relation to their credit profile, may find it difficult to raise capital through these instruments in the desired quantum.

Valuation of thinly traded perpetuals could become a challenge, leading to near-term volatility in AUM of AMCs and corporate bond yields

While perpetual debt instruments (PDIs) are issued by banks, NBFCs as well as corporates, banks are the largest issuers of perpetual bonds (also called Basel III Additional Tier I or AT-I bonds) in terms of issuance and outstanding volumes. As per ICRA's estimates, the total stock of AT-I bonds outstanding is Rs. 1.03 lakh crore as on February 28, 2021, of which 70% is issued by PSBs. Further, the PDIs outstanding of NBFCs and other corporates is estimated to be less than Rs. 10,000 crore, of which some portion is held by mutual funds.

Within banks, 15 PSBs and private banks (PVBs) have AT-I bonds outstanding; however, 10 banks have a meaningfully large stock (>Rs. 1,000 crore) of AT-I bonds outstanding. Hence, the issue of thinly traded PDIs and the consequent valuation based on 100-year maturity is likely to be limited to a few issuers. As these papers are currently valued on the residual time for the call option, a longer duration could impart volatility to the value of these bonds and hence the NAV of the mutual fund scheme. Moreover, identifying a 100-year benchmark security could be a challenge.

As the SEBI circular is effective from April 1, 2021, the impact of such a change in the valuation or the expected rise in the yield on these bonds could result in a decline in the NAV of some schemes, where these PDIs form a larger proportion of the AUM. As investors in such schemes could opt for heightened redemptions fearing a decline in the NAV, this could increase redemption pressure forcing the fund managers to liquidate other debt holdings in the scheme, thereby resulting in near-term volatility in the AUM of the AMCs as well as corporate bond yields.

Recapitalisation burden of GoI for PSBs could increase if markets remain dislocated for longer period

In ICRA's [outlook](#) for the banking sector for FY2022, we had estimated the Tier I capital requirements for PSBs at Rs. 43,000 crore for FY2022, of which Rs. 23,000 crore is on account of call options falling due on the AT-I bonds of PSBs while the balance is estimated as equity. In the Union Budget for FY2022, the Government of India (GoI) has already announced an allocation of Rs. 20,000 crore as equity capital for the recapitalisation of PSBs.

In case public banks are unable to replace the AT-I bonds with fresh issuances, the recapitalisation burden on the GoI could increase or these banks will have to curtail credit growth next year

Private banks are likely to maintain strong capital ratios even if they are unable to replace these bonds upon exercising the call option

If the market for AT-I bonds remains dislocated for a longer period for the reasons discussed earlier, and the PSBs are unable to replace the existing AT-Is with fresh issuances, this would mean that the PSBs could stare at a capital shortfall based on the budgeted capital.

ICRA also expects that the GoI will provide requisite support to the PSBs to meet the regulatory capital requirements, which means that the recapitalisation burden on the GoI could increase, or the PSBs could curtail credit growth amid uncertainty on the capital availability. Apart from Tier I, as mentioned earlier, there could be reduced appetite from mutual funds along with a rise in the cost of issuing Tier II bonds as the limited headroom for incremental investments in Basel III instruments.

Apart from PSBs, large private banks have sizeable maturities of AT-I bonds in FY2022 and FY2023. However, in ICRA's view, the issuing banks are comfortably placed to exercise the call options on the due dates and are likely to maintain a strong capital position, thereby limiting the need for replacement capital.

Given the larger implications of the SEBI circular, as per media articles, on March 11, 2021, the Finance Ministry has also requested the regulator to review the criterion for the valuation of PDIs. However, further developments in this respect are awaited.

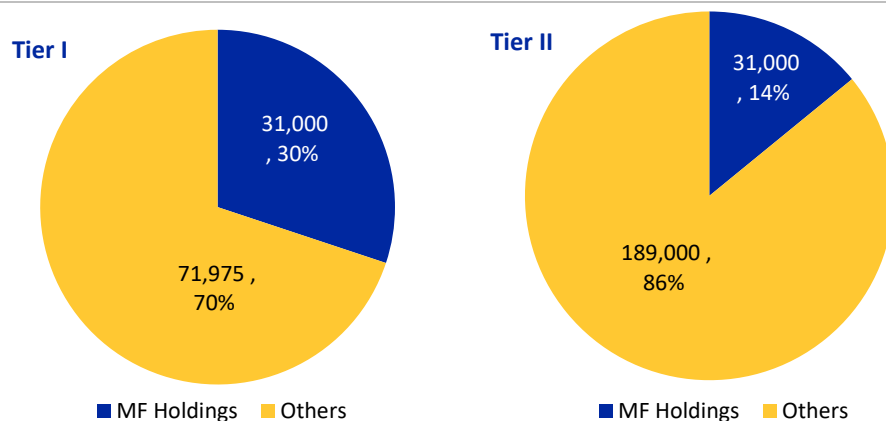
To sum up, while the move to limit investments in the instruments of a single issuer is a welcome measure and is in the interest of investors, it would pose challenges for the banks to raise sizeable capital through these instruments.

MUTUAL FUNDS ARE SIZEABLE INVESTORS IN BASEL III INSTRUMENTS OF BANKS

As shown in Exhibit 1 below, mutual funds are significantly large investors in the Basel III instruments issued by banks with even a relatively higher share of holding in AT-I bonds (as a percentage of outstanding bonds). Given the relatively higher yield on Tier I instruments in relation to Tier II instruments and the chasing of yields (with the perception of safety of a bank), mutual funds hold these bonds across various schemes like banking and PSU debt funds, corporate bond funds, credit risk funds, income funds, and saving funds to name a few.

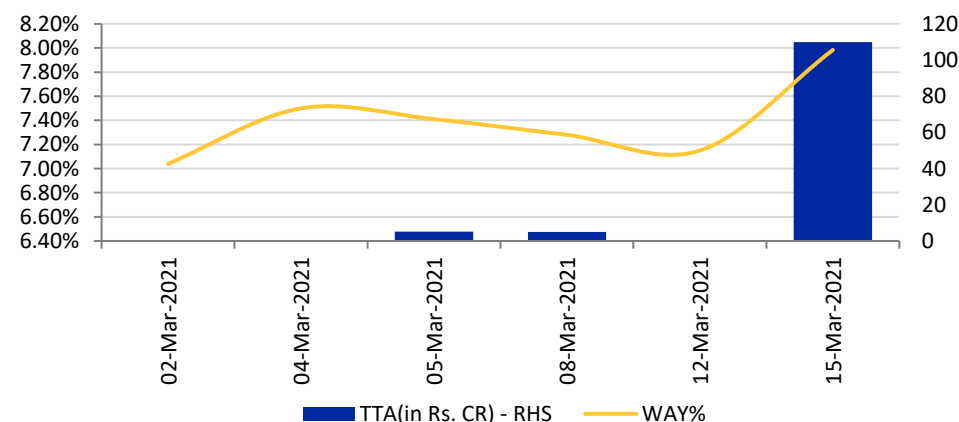
The AUM of mutual fund schemes where these bonds could be held is estimated at Rs. 8 lakh crore. With an estimated holding of Rs. 62,000 crore by mutual funds in these schemes, ICRA estimates the mutual funds' holdings across these schemes at 8% of the AUM of these schemes. Though this is lower than the 10% limit specified by SEBI for holding such bonds across all issuers, the appetite of mutual funds for fresh investments may be subdued as the headroom may be limited for incremental investments. This could result in higher issuance cost for banks, even while some banks may even find difficult to raise capital in the desired quantum.

EXHIBIT 1: Mutual Funds AT-I and Tier II bonds holdings are sizeable



Source: Industry data, ICRA research

EXHIBIT 2: Bond Yields and trading volumes have increased recently



Source: aimin.co., yield on SBI AT-I (ISIN – INE062A08223), ICRA research; TTA - Total traded amount; WAY - Wtd average yield

Moreover, with uncertainty regarding the impact of the change in the valuation of PDIs from April 1, 2021, mutual funds could face redemption pressure in the near term forcing the fund managers to liquidate the bond portfolios. As seen in Exhibit 2, the yield on the AT-I bonds of State Bank of India (SBI; rated [ICRA]AA+(hyb) (Stable) for AT-I bonds) has already seen an uptick in recent secondary market trades with higher trading volumes reflecting increased selling pressure. With SBI acting as a benchmark for the trading of other AT-I bonds, the yields are expected to rise across all issuers.

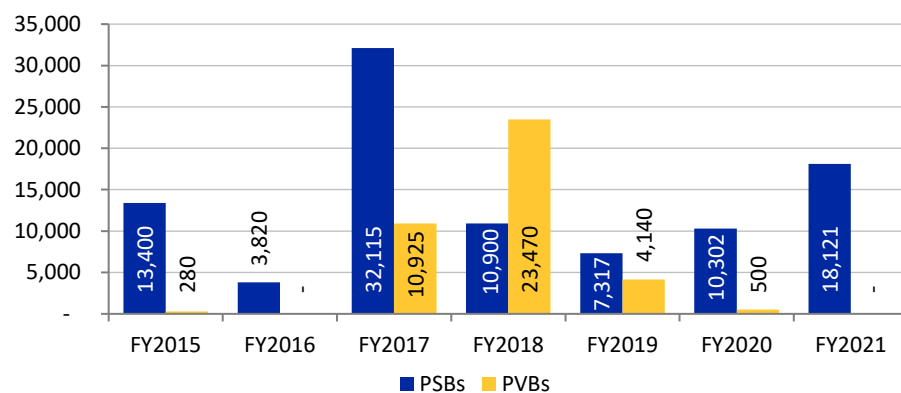
RECAPITALISATION BURDEN FOR GOI COULD RISE IF PUBLIC BANKS ARE UNABLE TO REPLACE AT-IS WHERE CALL OPTIONS FALL DUE NEXT YEAR

As shown in Exhibit 3, given the dominance of public banks in the Indian banking sector, PSBs have been a large issuer of AT-I bonds with issuances of ~Rs. 95,975 crore during FY2015-2021, whereas the issuances of private banks stood at ~Rs. 39,315 crore during the same period.

While PSBs have faced their own challenges for capital amid asset quality issues and consequent losses, thereby adversely impacting the coupon payment ability of AT-I bonds, examples of GoI support/regulatory forbearance (refer next page) have ensured that they continue to service these bonds. This has also resulted in improved investor appetite for the bonds of these PSBs as they are treated as a quasi-sovereign risk with better yields, thereby driving their issuance. After massive bank recapitalisation in FY2019 and FY2020, AT-I issuances remained muted during these years, though they picked up in FY2021 with more PSBs raising AT-I bonds compared to the past two years.

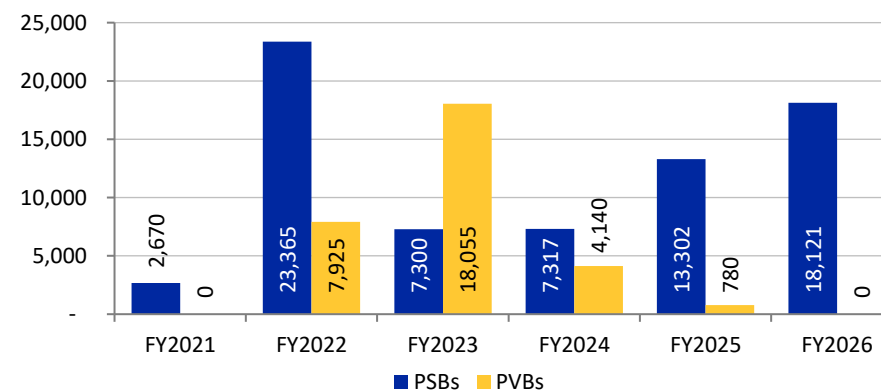
Improved AT-I issuance augured well for the GoI as it reduced its recapitalisation burden amid the rising fiscal deficit. However, as shown in Exhibit 4, PSBs have a sizeable quantum of AT-I bonds (Rs. 23,365 crore) for which the call option falls due in FY2022. Apart from growth capital requirements, public banks and the GoI would have been contemplating replacing these bonds with fresh issuances as a part of capital budgeting for next year.

EXHIBIT 3: Trends in AT-I issuance by banks



Source: ICRA research

EXHIBIT 4: Year-wise Call-option on AT-I bonds outstanding



Source: ICRA research

With recent developments, the uncertainty regarding the ability of PSBs to replace the AT-I bonds at competitive rates as well as the desired amount has increased. In case these banks are unable to replace this capital with fresh bond issues, they will have to either curtail their credit growth plans or the recapitalisation burden on the GoI could rise. While there could be challenges in replacing the capital, ICRA continues to factor in the requisite capital support from the GoI for PSBs, to enable these banks to meet the regulatory capital ratios. Hence, the event is likely to be credit neutral for public banks. On the other hand, private banks that have a major chunk of AT-I bonds outstanding have raised sizeable capital/have a strong capital position, which is unlikely to weaken if these banks are unable to replace the AT-I bonds falling due for a call option.

Related ICRA articles on AT-I instruments

1. [Investors in Additional Tier-I bonds should be mindful of possibility of coupon skip – October 2017](#)
2. [Risk of coupon skip subsides as weak PSBs initiate early recall of their AT-I bonds – February 2018](#)
3. [Equity capital requirements for banks could increase as risk aversion for AT-I bonds likely to go up – March 2020](#)
4. [ICRA's bank rating methodology – August 2020](#)
5. [Accounting adjustments to improve serviceability of Additional Tier I bonds of public sector banks – October 2020](#)

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 AT-I BONDS ISSUANCES

	Total Issuance [^]	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
Bank of Baroda	14,207	1,900	1,500	2,325	1,350	-	3,397	3,735
Bank of India	6,250	2,500	-	2,500	500	-	-	750
Bank of Maharashtra	1,500	1,000	-	500	-	-	-	-
Canara Bank	8,686	1,500	870	2,930	450	-	-	2,936
IDBI Bank	5,000	2,500	-	2,500	-	-	-	-
Indian Overseas Bank	4,000	-	500	300	1,200	-	-	2,000
Indian Bank	1,000	1,000	-	-	-	-	-	-
Punjab National Bank	9,195	2,000	150	3,950	2,600	-	-	495
Punjab & Sind Bank	1,000	-	-	-	1,000	-	-	-
State Bank of India	33,932	-	-	11,210	2,000	7,317	6,905	6,500
UCO Bank	750	-	-	750	-	-	-	-
Union Bank of India	10,455	1,000	800	5,150	1,800	-	-	1,705
Total Public Banks	95,975	13,400	3,820	32,115	10,900	7,317	10,302	18,121
Axis Bank	7,000	-	-	3,500	3,500	-	-	-
HDFC Bank	8,000	-	-	-	8,000	-	-	-
ICICI Bank	10,120	-	-	3,425	5,555	1,140	-	-
IndusInd Bank	4,000	-	-	1,000	1,000	2,000	-	-
Jammu & Kashmir Bank	1,000	-	-	-	-	1,000	-	-
South Indian Bank	500	-	-	-	-	-	500	-
Yes Bank	8,695	280	-	3,000	5,415	-	-	-
Total Private Banks	39,315	280	-	10,925	23,470	4,140	500	-
Total Public + Private Banks	135,290	13,680	3,820	43,040	34,370	11,457	10,802	18,121

[^] Total Issuances till February 28, 2021,

Issuances by various erstwhile PSBs are included in the issuances of amalgamating bank

Source: ICRA Research

ANNEXURE 2: BANK-WISE AT-I BONDS OUTSTANDING AND YEAR-WISE CALL OPTION

	Outstanding [^]	FY2021	FY2022	FY2023	FY2024	FY2025	FY2026
Bank of Baroda	11,307	500	2,325	1,350	-	3,397	3,735
Bank of India	750	-	-	-	-	-	750
Canara Bank	8,686	870	2,930	450	-	1,500	2,936
Indian Bank	2,500	500	-	-	-	-	2,000
Punjab National Bank	5,745	-	2,250	1,500	-	1,500	495
Punjab & Sind Bank	1,000	-	-	1,000	-	-	-
Union Bank of India	7,355	800#	4,650	1,000	-	-	1,705
State Bank of India	33,932	-	11,210	2,000	7,317	6,905	6,500
Total Public Banks	71,275	2,670	23,365	7,300	7,317	13,302	18,121
Axis Bank	7,000	-	3,500	3,500	-	-	-
HDFC Bank	8,000	-	-	8,000	-	-	-
ICICI Bank	10,120	-	3,425	5,555	1,140	-	-
IndusInd Bank	4,000	-	1,000	1,000	2,000	-	-
Jammu & Kashmir Bank	1,000	-	-	-	1,000	-	-
South Indian Bank	5,00	-	-	-	-	500	-
Yes Bank	280	-	-	-	-	280	-
Total Private Banks	30,900	-	7,925	18,055	4,140	780	-
Total Public + Private Banks	102,175	2,670	31,290	25,355	11,457	14,082	18,121

[^] Outstanding as on February 28, 2021, # Call option exercised in February 2021
 Call option for FY2021 includes all the bonds where call-option was due during FY2021.
 Source: ICRA Research

ABOUT ICRA

ICRA Limited (formerly Investment Information and Credit Rating Agency of India Limited) was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

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- Assist the regulators in promoting transparency in the financial markets;
- Provide intermediaries with a tool to improve efficiency in the funds raising process.

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