

Indian Banking Sector:

Risk of coupon skip subsides as weak PSBs initiate early recall of their AT-I bonds



ICRA

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A photograph of a modern glass skyscraper facade. The word 'Bank' is written in large, white, 3D block letters on the glass surface. The lines of the building's grid create a strong sense of perspective, leading the eye towards the top of the frame.

Bank

HIGHLIGHTS

- *During the last four years, Public Sector Banks (PSBs) have raised Additional Tier – I (AT-I) bonds totalling Rs 60,385¹ crore to shore-up their Tier-I capital ratios in the backdrop of losses, increasing capital requirements under Basel III and limited capital infusion by the Government of India (GoI) in relation to their requirements.*
- *With losses during the last three years, 11 out of 21 PSBs have been placed under the Prompt Corrective Action (PCA) framework by the Reserve Bank of India (RBI). Inclusion in PCA coupled with recapitalisation of PSBs by the GoI has triggered a ‘Regulatory event’ and an early recall of AT-I bonds by banks under the PCA. These 11 banks account for Rs 21,900 crore of AT-I bonds, which are likely to be called off during the next few weeks.*
- *Additionally, five more PSBs can come under the PCA framework, which if happens, will result in an additional recall of Rs 15,700 crore of AT-I bonds.*
- *While the recapitalisation of PSBs was expected to improve their capital ratios, huge losses during Q3 FY2018 and an early recall of AT-I bonds is likely to partially negate the recapitalisation programme of GoI. Depending on AT-I bonds issued by individual bank, the capital ratios can reduce by 0.7-2.0% of risk weighted assets of these banks.*
- *Cumulatively the PSBs have reported losses before tax of over Rs 92,000 crore during Q3 FY2016-Q3 FY2018 (Rs 49,379 crore in H2FY2016, Rs 7,041 crore in FY2017 and Rs 35,600 crore during 9M FY2018). With huge losses, the PSBs’ ability to service these AT-I bonds while adhering to their regulatory features had been steadily weakening as these bonds can be serviced through profits of the year or accumulated profits (in case there is a loss during the year).*
- *Though the Tier I capital ratios are likely to weaken on the early recall of these AT-I bonds by PSBs, however, the risk of coupon skip by weaker PSBs on their AT-I bonds has significantly been reduced.*
- *Some of the investors who could have bought these bonds from the secondary market at a premium (higher than face value), may stand to lose as the early redemption by banks is likely to be done at face value. However, with riskier features like “write-down” clause in these bonds, it may be a positive for investors in some of the weaker PSBs*

Recently, two public sector banks (PSBs) have issued notices to their additional tier I (AT-I) bondholders intimating them about an exercise of early call option on their AT-I bonds. In ICRA’s view, despite the recent recapitalisation by the Government of India (GoI), if banks which are currently under prompt corrective action (PCA) framework were to recall their AT-I bonds, some of these may not be able to meet Tier I regulatory requirements² as on March 31, 2018.

As on December 31, 2017, the PSBs had AT-I bonds outstanding of Rs 60,385 crore (refer chart 1 on page 4). Out of the PSBs that are currently under PCA or likely to come under PCA, nearly ~60% of AT-I bonds totaling Rs 37,600 crore can be prematurely recalled by banks. With capital infusion of Rs 80,562 crore during Q4 FY2018 (refer chart 2 on page 4), the effective recapitalisation will stand reduced for many PSBs. Accordingly, despite recapitalisation some banks can potentially be lower than the regulatory Tier I capital requirements (including capital conservation buffer) for March 31, 2018 (refer chart 4 on page 4).

¹ Including overseas issuance of State Bank of India (SBI), but excluding issuances by erstwhile associates SBI, whose AT1s stands extinguished upon merger with SBI

² Tier I regulatory requirement of 8.875% of risk weighted assets (RWA) including capital conservation buffer of 1.875% of RWA

As per stock exchange filings by two PSBs (Bank of Maharashtra and Oriental Bank of Commerce) and notice to bondholders of these banks, the Reserve Bank of India (RBI) has confirmed to GoI that the inclusion of a bank under the PCA framework as a 'Regulatory Event'. Further, as per the terms of the AT-I bonds, banks have a right to exercise an early call option on their AT-I bonds, upon occurrence of regulatory event, among others, provided these are replaced with similar or better quality capital. This, coupled with confirmation by the RBI that capital infused under the recent recapitalisation programme of the GoI can be utilised to replace the existing AT-I bonds and subsequent instructions from the GoI to recall their AT-I bonds, has triggered early calls by banks.

The RBI has already invoked the PCA on 11 out of 21 PSBs (of which 10 banks have issued AT-I), and based on the PCA framework, as per ICRA's estimates, five more PSBs can fall under the PCA framework (refer Exhibit 1 on page 5). Earlier, during January 2018, the GoI had instructed the PSBs to not issue AT-I without its prior approval. Accordingly, the weak banks will require to raise equity capital to meet their overall Tier I requirements, which otherwise could have been met through AT-I bonds.

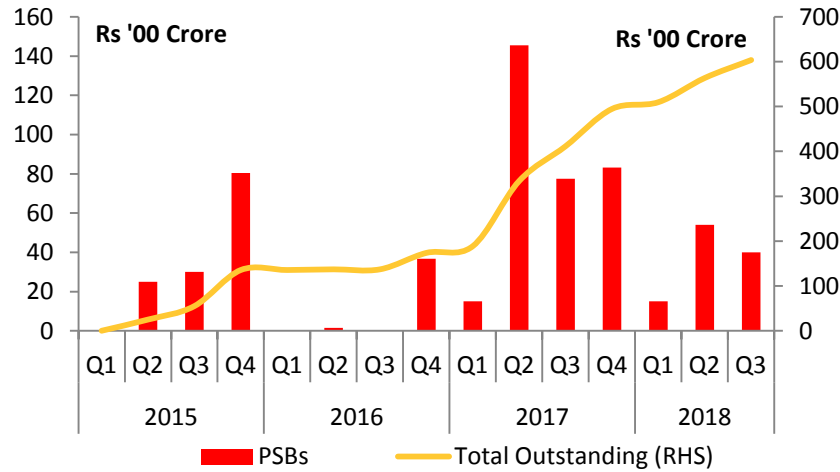
With huge losses during the last three years, the ability of the PSBs to service these AT-I bonds had been steadily weakening as these bonds can be serviced through profits of the year or accumulated profits (in case there is a loss during the year). With continued losses and significant erosion in accumulated profits, the serviceability of these bonds, while adhering to regulatory features of these bonds, was becoming a challenge for PSBs. This had also created an ambiguity among the investors on likely skip of the coupon by weaker PSBs on their AT-I bonds. Cumulatively the PSBs have reported losses before tax of over Rs 92,000 crore during Q3 FY2016-Q3 FY2018 (Rs 49,379 crore in H2FY2016, Rs 7,041 crore in FY2017 and Rs 35,600 crore during 9M FY2018). The recent revision in guidelines for resolution of stressed assets is likely to result in further deterioration in reported non-performing assets and increase the credit provisioning requirements for banks, which will further pressurise the profitability of the banks in the near term. Hence the capital ratios are expected to be weaker than the estimated capital ratios in chart 4 on page 4.

With continued losses, the regulations related to coupon servicing on these bonds were also relaxed in the past to enable PSBs to service coupon on these bonds. During FY2018, as per ICRA's estimates, some PSBs also paid coupon on their AT-I bonds, despite breaching the regulatory criterion for coupon servicing on these bonds. ICRA, in its earlier note released during October 2017, ['Investors in AT-I bonds should be mindful of possibility of coupon skip'](#) has highlighted the risk on these AT-I bonds and also reiterated that if these AT-I bonds are not allowed to absorb losses, it will be prudent to not accord Tier I capital status to these bonds. This otherwise creates an illusion of comfortable capitalisation, which is misleading, if these bonds are not allowed to absorb losses.

Though the Tier I capital ratios are likely to weaken in relation to regulatory requirements upon the early recall of these AT-I bonds by PSBs, however, the risk of coupon skip by weaker PSBs on their AT-I bonds will significantly reduce. Some of the investors who could have bought these bonds from the secondary market at a premium (higher than face value), may stand to lose as the early redemption by banks is likely to be done at face value. However, with riskier features like the "write-down" clause in these bonds, it may be a positive for investors of AT-I bonds issued by the weaker PSBs.

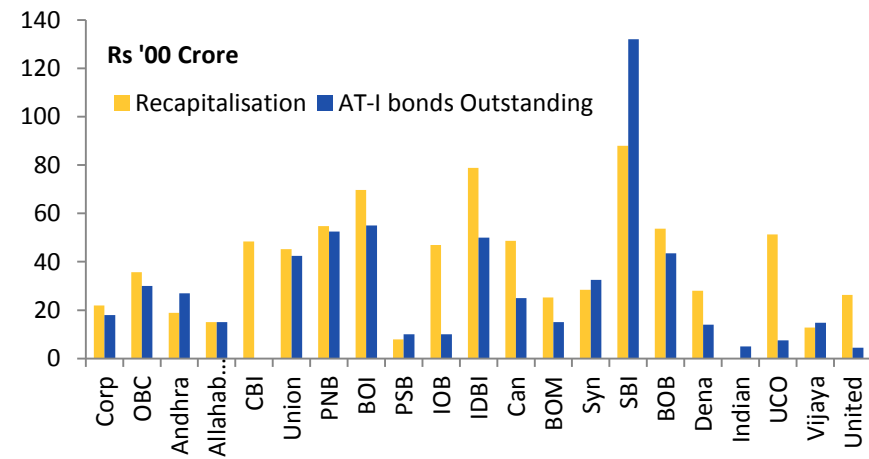
Recall of AT-I bonds to weaken the capital ratios for some of the PSBs

Chart 1: Trend in AT-I bond issuance by PSBs (excl SBI associates)



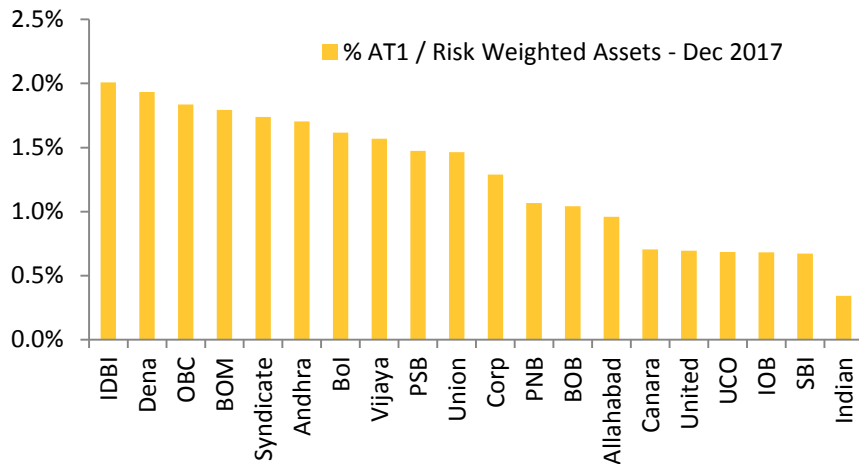
Source: NSDL, Bank, ICRA Research.

Chart 2: Bank wise Recap (post Dec 31 2017) Vs AT- Bonds outstanding



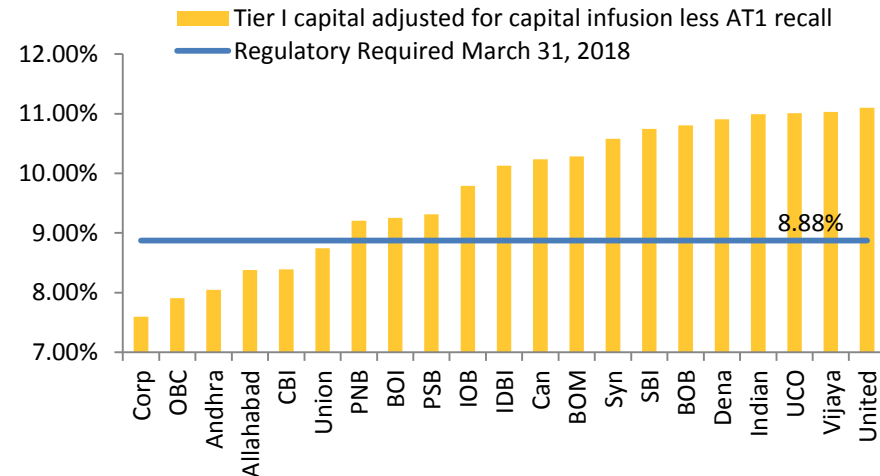
Source: Gol, Banks, NSDL, ICRA Research.

Chart 3: AT-I bonds outstanding as % of Risk weighted assets



Source: Banks, NSDL, ICRA Research

Chart 4: Adjusted Tier I capital (Reported Tier I as on December 31, 2017 + Recapitalisation capital less recall of AT1s, if bank under PCA/Likely to come in PCA)



Source: ICRA Research

Exhibit 1: Bank-wise impact of recall on AT-I bonds

Bank Name	Is Bank under PCA?	%Net NPA		Capital infusion by GoI after December 31, 2017		CET1 as on Dec 2017	Tier 1 as on Dec 2017	AT-I bonds Outstanding	AT-I bonds likely to be recalled. PCA bank/Likely PCA bank	Tier I capital adjusted for recapitalisation less AT1 recall	Cushion vs regulatory requirement ^{&} as on March 31 2018
		Mar-17	Dec-17	Rs Crore	as % of RWA						
				A	B	C	D	E	F	G=D+A-F	G – 8.875%
Corporation Bank	Yes	8.3%	10.7%	2187	1.6%	5.77%	7.3%	1800	1800	7.60%	-1.3%
Oriental Bank of Commerce	Yes	9.0%	9.5%	3571	2.2%	5.56%	7.6%	3000	3000	7.91%	-1.0%
Andhra Bank	No, but can be included [#]	7.6%	7.7%	1890	1.2%	6.79%	8.6%	2700	2700	8.05%	-0.8%
Allahabad Bank	Yes	8.9%	9.0%	1500	1.0%	7.33%	8.4%	1500	1500	8.38%	-0.5%
Central Bank of India	Yes	10.2%	9.4%	4835	2.5%	5.87%	5.9%	0		8.39%	-0.5%
Union Bank of India	No, but can be included [#]	6.6%	7.0%	4524	1.6%	7.18%	8.7%	4250	4250	8.74%	-0.1%
Punjab National Bank	No, but can be included [#]	7.8%	7.5%	5473	1.1%	8.05%	9.2%	5250	5250	9.21%	0.3%
Bank of India	Yes	6.9%	10.3%	6975	2.0%	7.06%	8.8%	5500	5500	9.25%	0.4%
Punjab and Sind Bank	No, but can be included [#]	7.5%	7.2%	785	1.2%	8.12%	9.6%	1000	1000	9.31%	0.4%
Indian Overseas Bank	Yes	14.1%	13.1%	4694	3.2%	6.54%	7.3%	1000	1000	9.79%	0.9%
IDBI Bank	Yes	13.2%	16.0%	7881	3.2%	6.62%	9.0%	5000	5000	10.13%	1.3%
Canara Bank	No, but can be included [#]	6.3%	6.8%	4865	1.4%	8.75%	9.6%	2500	2500	10.24%	1.4%
Bank of Maharashtra	Yes	11.8%	12.2%	2523	3.0%	7.23%	9.1%	1500	1500	10.28%	1.4%
Syndicate Bank	No	5.2%	5.4%	2839	1.5%	7.15%	9.1%	3250		10.58%	1.7%
State Bank of India	No	3.7%	5.6%	8800	0.4%	9.60%	10.3%	13210 [^]		10.75%	1.9%
Bank of Baroda	No	4.7%	5.0%	5375	1.3%	8.28%	9.5%	4350		10.81%	1.9%
Dena Bank	Yes	10.7%	11.5%	2802	3.9%	7.11%	9.0%	1400	1400	10.91%	2.0%
Indian Bank	No	4.4%	3.3%	0	0.0%	10.64%	11.0%	500		10.99%	2.1%
UCO Bank	Yes	8.9%	10.9%	5132	4.7%	6.33%	7.0%	750	750	11.01%	2.1%
Vijaya Bank	No	4.4%	4.0%	1277	1.4%	8.26%	9.7%	1475		11.03%	2.2%
United Bank of India	Yes	10.0%	11.9%	2634	4.1%	6.28%	7.7%	450	450	11.10%	2.2%
Total				80,562[§]	1.5%			60,385	37,600		

[#] Based on threshold of Net NPAs > 6% as per PCA framework; [^] includes US\$ 300 million overseas issuance

[&] Based on Tier I capital requirement of 7% plus the capital conservation buffer of 1.875% totaling Tier I requirement of 8.875%. Does not include the likely losses and capital raising banks may report during Q4FY2018

[§] GoI had announced a capital infusion Rs 88,139 crore into PSBs during January 2018, however of this, Rs 7,757 crore was already infused in six PSBs on December 29, 2017 and hence included in the capital ratios of December 31, 2017.

Source: ICRA Research, Banks results, NSDL.

Document dated 27 Feb 2018 has been corrected with revisions as detailed below:

Exhibit 1 – Page 5
Capital infusion by GoI and CET I as on December 2017



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