

Investors upset as four banks recall Rs 109-bn additional tier 1 bonds

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Anup Roy & Namrata Acharya March 08, 2018 Last Updated at 21:16 IST



With four banks recalling their additional tier 1 bonds (AT1), issued as quasi-equity under Basel-III regulations, the stage is all set for a slow death of these perpetual instruments in the investor community.

To date, Rs 761.14 billion of these bonds have been issued in the local markets, including by private banks and Exim Bank of India. State Bank of India's Dubai branch raised another \$300 million in AT1 bonds overseas. Almost all banks issued these bonds.

Out of the 11 banks undergoing prompt corrective action (PCA) of the Reserve Bank of India (RBI), which restricts normal lending activities of banks, nine had raised Rs 202.9 billion from these bonds.

Bank of Maharashtra, Oriental Bank of Commerce, Dena Bank and IDBI Bank have recalled Rs 109 billion worth of these bonds from the market after the government prompted them to do so.

Incidentally, the AT1 bond crisis in India mirrors what happened in Europe two years ago, but none of the Indian banks has defaulted or deferred its

payment obligations. With the recall of these bonds, the chances of a future default are eliminated substantially, said rating agency Icria. Other banks under PCA are also on their way to doing the same.

“Under two circumstances — tax and regulatory events – are banks are allowed to recall AT1 bonds. In our case, the government stepped in and said PCA was a regulatory event.

Therefore, we got the government instruction to recall the AT1 bonds,” said a senior official of Kolkata-based United Bank of India.

The official said the bank had sought clarification on this issue and based on the feedback, the recall was to be exercised. There could be an option to replace the AT1 bonds with better quality bonds, but the coupon could be less.

“In fact, if AT1 bonds are replaced by a better quality bond, we will save on the coupon rate. However, for that, it is essential to get the government’s capital infusion on time,” said the official.

The bonds were high yield instruments, offering yields of as high as 11.85 per cent (in case of Allahabad Bank and Indian Overseas Bank), and since these bonds were offered by public sector banks (PSBs), with an implicit guarantee of the government, investors lapped them up. The reason for such a high yield was that the bonds originally had a loss absorption clause, which meant if a bank was to make a loss, it could defer or cancel payment of coupons. However, given the condition of the banks, the RBI stepped in and allowed banks to dip into past reserves of the banks to pay the coupon.

Given the high yields, there is a secondary market for these bonds, but trades happen infrequently. Essentially, investors hold them for a few months and sell in a lot of Rs 1-3 billion.

The yield movement in these bonds is extremely volatile.

According to market sources, one particular state-owned bank’s yields jumped to 14 per cent, against its coupon of 10.9 per cent, the day the bank reported a loss of more than Rs 30 billion in a quarter. The coupon fell recently to 10.5 per cent after the government said it would recapitalise the bank handsomely.

For some banks with bad debt ratio in double digits of advances, even the reserves were not adequate. Banks were struggling to meet their coupon payment obligation and this recall could save them from the pain, said Icra. But with recalling of the bonds itself, likely by paying through the same dwindling reserves, banks are potentially staring at a situation where they will not be able to get out of PCA for a long time, unless the government stepped in with more capital, said analysts. For investors though, the recall was a jolt.

Mutual funds (MFs) were the major buyers of these bonds, while some high net worth individuals (HNIs) were also sold these bonds by brokers. Banks lobbied for selling these bonds to retail investors, but the regulators turned them down for being risky instruments. Some banks, particularly the underwriters, bought these bonds, but there were restrictions.

Insurance companies were latecomers in the field, as the insurance regulator allowed them to buy these bonds only in December 2016.

Some of the worst-hit would be MFs and HNIs that had bought these bonds, particularly for their “balanced fund” schemes. Now that the bonds are getting recalled, the net asset value of these MFs would be hit as they will not be able to earn high yields on alternative instruments and investors would suffer.

But MFs still have a large balance sheet size and sophisticated risk management system to tide over the crisis, but some HNIs have started complaining to brokers who sold them these bonds.

“The brokers made fat money by selling AT1s of weak banks. The scope for getting money in better banks was limited and the effort was more for selling bonds of banks under severe stress,” said an investment banker.

“The bonds were sold showing high yields and promising that the government would always support PSBs. These were touted as the safest high-yield instruments,” said a banker requesting anonymity.

Corporate bond dealers said for some time these bonds were doing fine, and in the secondary market daily trade was about Rs 500-800 million, but after the Insolvency and Bankruptcy Code induced stress and provisioning burden on banks, investors started getting cautious. The trading virtually stopped for all PSB AT1 issuances after the Nirav Modi scam. The last trade in the space happened on the bonds of HDFC Bank. About Rs 600 million bonds were sold in the market by an investor two days back, said dealers.

However, bond dealers said, the chances of investors coming to buy banks' AT1 bonds have all but evaporated and PSBs will now have to be solely dependent on the government to raise equity.