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on

A study on the AT1 Bonds in India vis-à-vis other jurisdictions

By:

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- Additional Tier 1 (AT1) bonds are capital instruments with debt like features and act as key regulatory bail-in instruments outside the normal bankruptcy process imposing principal losses on creditors in case of firm specific events. The primary purpose of institutionalising AT1 bonds has been to enhance the resilience of banks by ensuring orderly re-capitalization and liquidation of banks without leading to any domino impact on the banking or financial system.
- Based on the stipulated features, AT1 instruments have two defining characteristics – the loss absorption mechanism and the trigger that activates this mechanism. The loss absorption mechanism occurs either by AT1 bonds converting into common equity by or through a complete or partial, permanent or temporary principal write-down, based on pre-defined trigger point, either quantitative or qualitative. The quantitative trigger is generally defined numerically in terms of a specific capital ratio/fraction of risk-weighted assets or it can also be discretionary based on supervisory assessment (statutory power or contractual terms), when the bank is assessed to be non-viable and the trigger is necessary. The write-down is also affected in cases prior to recapitalisation of a bank with public funds.
- The global AT1 market is worth roughly $969 billion as of March 2024 with Asia having the major share of around $577 billion, followed by Europe with $211 billion and preference shares in United States of America (USA) with a market of around $182 billion. Globally, the CNY is the currency with maximum share of issuance in AT1 followed by USD and EUR. With regard to the principal loss absorption mechanism, AT1 instruments with write-down feature has been observed to the prominent issuance type both in Europe as well as in Asia. However, the proportion of write-down issuance is greater in case of Asia. In the write-down category, there appears a complete contrast between the issuances in Asia and Europe. While European write-down issuances are primarily temporary write-downs, in contrast, the Asia write-down issuances are primarily permanent in nature.
- The maturity of the AT1 bonds is broadly perpetual across the globe and are mainly issued as subordinated debt. The coupon reset dates have been observed to be coincident with the first call date. As required in the Basel guidelines, dividend pusher feature is not observed in any jurisdiction globally. However, the dividend stopper guidelines are present globally in most of the jurisdictions. With respect to dividend distribution, dividends are observed to be fully discretionary (non-cumulative) and subject to distributable reserves and capital buffers.
- There is a lot of variation observed in the requirements for going concern Common Equity

Tier 1 (CET1) loss absorption triggers across the geographies. Geographies such as China, Singapore, Hong Kong, Korea, USA and Canada have no stipulated trigger requirements. However, for Australia, European Union (EU), United Kingdom (UK), India, Thailand and Switzerland, CET1 requirements ranges from 5.125% to 7%. There are also a lot of variances in the loss absorption manner wherein some jurisdictions provide only for conversion to equity while some for permanent and temporary write-downs.

- With respect to the discretionary trigger of non-viability, stipulations across jurisdictions are based on contractual agreements, statutory or both. In case of contractual stipulations, the provision of loss absorption trigger is mentioned in the AT1 contract itself. Statutory stipulation requires that in case resolution is invoked, creditor hierarchy has to be respected via "no creditors worse off than in liquidation principle". China, Australia, Korea, Thailand, India and Canada have contractual stipulations. Hong Kong, Singapore and Switzerland have both the stipulations. EU, UK and USA have the statutory stipulations.
- Globally, the major investor groups for AT1 instruments include Asset Managers, Banks, Family Office/Professional Investor/Private Bank customer, Hedge Funds, Insurer (investing policy holder liabilities), Pension Funds, Preferred Funds/CoCo Funds and Sovereign wealth funds. Most global investors do not have any rating restrictions for making investments except for Asian markets. Relative outright value of AT1 bonds within the asset class appeared to be the most quoted reasons for investing in AT1s. Investors and banks use yields and credit spreads (Z-spreads and 5-year swap spreads) to value the AT1 bonds.
- The market expectations about issuers invariably calling the AT1 bonds at first call date has been replaced with the understanding that the issuers may prefer calling the AT1 bonds at the first call date but may choose not to if the economics are very unfavorable. Hedging with respect to AT1 bonds was not being done by majority of the investors. As a tool to reduce refinancing risk and enhancing primary market efficiency, many banks in UK and EU combine fresh AT1 capital issuances with the concurrent repurchases of outstanding AT1 capital instruments, often termed as "tender offer".
- As on March 2024, the total amount of AT1 instruments outstanding in Indian markets is ₹ 1,28,147 crores, with the issuance being dominated by Public Sector Banks. There appears to be a wide variability in the respective coupons and the spreads prior to 2020-21 which have appeared to narrowed down over the post 2020-21 period, mainly attributed to bank consolidation. There has been stability in the levels of the coupons and the reduction in the spreads appear to reflect upon the healthy condition of the Indian Banking sector, better balance sheets, as well as the overall strength of the financial sector in general. There do not appear to be any direct relationship between the issuance of AT1 bonds and Gross Non-Performing Assets (GNPAs), however, we may infer expected write-offs to be directionally related to the issuance of the AT1 bonds.
- The Indian AT1 market has seen several regulatory interventions coordinated with the Government to avoid any coupon deferral or loss to investors in these instruments. The domestic AT1 bond market is limited due to the lack of a vibrant secondary market for bonds. For the Indian markets, the AT1 bonds are invariably assumed to be called on the first call date and this has been the practical norm.
- AT1 bonds are complex instruments. Given the risks involved in investing in AT1 instruments, one key risk to the AT1 market is around investor confidence. Over the recent past,

there has been several events of the writing off of AT1 bonds issued. In case, the respective jurisdiction has statutory guidelines in terms of resolution framework or other guidelines, then the contractual terms must coincide with the statutory terms and the competent authority puts the bank in resolution simultaneously writing-down the AT1 bond. Generally, the resolution frameworks mandate the creditor hierarchy to be followed and thus, in these cases, the write-down of AT1 bonds prior to write-down of shareholders' equity is prevented.

- In cases where there are no such statutory/ resolution provisions or the contractual terms are not fully aligned with the respective statutory guidelines or the respective statutory framework, do not put specific restrictions on the wipe-out of the AT1 bonds without the wipe-out of CET1, then in these cases, the write-down of AT1 bonds prior to write-down of shareholders' equity is possible. Thus, there is considerable complexity in understanding the nuances of the AT1 bonds which would be a daunting task for any retail investor and thus, only specialised investors may be required to be allowed to invest in these instruments.
- Placement memorandum (along with term sheet) is the official document which has been prescribed for issuance of corporate bonds in India as per Securities and Exchange Board of India (SEBI) guidelines, as compared to Placement Prospectus in EU. Even though the term-sheet field list has been prescribed, variability has been observed in the disclosures provided in the term sheets particularly with respect to the write-down, exercise of call options, exercise of Point of Non-Viability (PONV) stipulations. Given the technicalities and intricacies involved in various situations in which the write-down may occur, the disclosures need to be simple and well-explained. With respect to mis-selling, the regulators may mandate nuanced and to the point disclosures in the application forms or the selling team to individually apprise the customers and getting those signed as part of the investment document, so that the product is adequately explained, all related information is provided and the investors make an informed investment decision.
- The Indian corporate bond market is still evolving. The Indian corporate bond market is completely dominated by private placement issuances and public issuances have been limited. From a ratings perspective, the corporate bond market is highly skewed by issuers which are highly rated with AAA and AA rated issuers forming the 75-80% of the issuance. Further, majority of the issuances in the corporate bond market are fixed rate issuances and the floating rate issuances are minimal. The corporate bond market is also dominated by issuances from financial corporations; however, the share of non-financial corporations has also risen over the years. There is limited trading in the secondary bond market.
- Banks along-with AT1 bonds also issue other bonds such as infrastructure bonds. Given that domestically, the bonds are issued by banks as part of the corporate bond markets, hence, the bank bond markets including the AT1s parallel the nature of the corporate bond markets. AT1 bonds are at the riskier end of the fixed income bonds as they are lower rated than more senior debt, therefore, the relative higher yield offered by AT1 bonds may be assumed to be driven by their subordination in the capital structure, rather than a reflection of the respective bank's credit quality.
- Credit rating agencies generally follow the practice of "notching", wherein the different issuances of same borrowers are rated differently based on the risk perceptions. AT1 bonds, based on loss absorption features and thereby, inherently

considered more risky are generally notched down from similar issuances of the banks. The corporate bonds are generally being priced based on the ratings with the highest ratings having the smallest coupon and the weakest ratings having the highest coupons. A comparison of the coupons with the bonds of the Banks reveal that as we go down the rating chart, the difference in the coupons become more stark.

- In the Indian context, there is a need for harmonization on the valuation aspect of the AT1 bonds which is not as what is observed globally. There is need to bring in more customer awareness with respect to the various scenarios related to the write-down/write-off of AT1 bonds. Regulators may also issue Frequently Asked Questions (FAQs) detailing all the aspects so that the customers can get an authentic information source on the AT1 bonds. The prospectus memorandum for the issuance of AT1 bonds may be made more focused with respect to the risk disclosures. The limitations of the corporate bond market which also affects the AT1 bond market such as non-availability of indices/benchmarks, lack of depth in Credit Default Swap (CDS) market, lack of depth in secondary markets, primary market being highly privately placed making effective price discovery limited, limited avenues for hedging instruments etc. are required to be addressed.
- Unlike as observed world-over, AT1 bonds in the form of contingent convertible are not allowed in India as part of capital. With the deepening of capital markets and efficient price discovery being facilitated, this aspect may also be reviewed. Further, the Perpetual Non-Cumulative Preference Shares (PNCPS) issuance in India is limited even when we have a vibrant capital market. A well-developed PNCPS market will augur well for capital raising by the banks and will add to the variety of instruments available for the same.

IIBF inaugurated Professional Development Centre at Guwahati

IIBF is pleased to announce that a new Professional Development Centre (PDC) at Guwahati has been established. The PDC was inaugurated by the President of the Institute Shri. M. V. Rao on June 6, 2025. Mr. Binay Kumar Singh has joined the Institute as Head-PDC, Guwahati. For more details, please contact on head-pdcgau@iibf.org.in

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