IS THE RISK REWARD TURNING FAVOURABLE FOR MAKING INVESTMENTS IN BANK AT1 BONDS

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Typical retail mindset about fixed income historically has revolved only around fixed deposits with banks. The preference for liquidity, safety and unavailability of credible options led to subdued participation in direct bond investments. However, with the economy moving towards a lower interest rate structure, more and more investors are looking to diversify into bonds and debentures in search of higher yields. One such category of high yielding debt popular today is of Basel III Additional Tier I (AT1) perpetual bonds issued by banks.

AT1 bonds are instruments without any defined maturity, however supplemented with a call option (usually after 5 years). The attraction around these bonds is the superior yield they offer vis – a – vis other secured bank bonds. Currently, the highest rated banks (AA+) offer pre-tax yields of ~ 8% to 9%, while the lowest rated banks offer ~ 12% to 13%. However, these bonds come with a two-fold risk. First, banks can skip coupon payments if they do not have sufficient reserves. Second, being part of Tier I capital, these bonds have loss absorption features, which could result in loss of capital in extreme cases.

Public-Sector Banks (PSBs) have been going through a tough phase since the past couple of years. RBI's asset quality review coupled with slowdown in certain sectors has led to high scale recognition of bad loans. Provisioning for these stressed assets has eroded profitability and even reserves of some PSBs. The capital position of the banks suffered, leading to increased risks of banks skipping coupons on AT1 bonds. However, RBI has time and again eased rules surrounding coupon servicing of these bonds while the government has shown willingness to capitalize struggling PSBs whenever needed. The latest regulation change by RBI allowing banks to dive into their statutory reserves boosted the coupon servicing capability of the banks considerably.

The activity in the market for AT1 bonds has come down a bit in the recent past. Insurance companies have approvals but their buying interest is limited to higher rated bonds only.

Mutual funds have been large investors in the past. Cash surplus treasuries of large corporate houses have recently started showing some interest in these instruments. Further, issuers are looking to issue more of these bonds to bolster their capital. Thus, the AT1 market appears to be in a state of flux at the moment, which could provide an investment opportunity.

Some positive developments that could support this market going forward can be listed as under:

- **PCA framework:** The revised Prompt Corrective Action framework by the RBI has been put into place and initiated for six banks. This is aimed at bettering the health of these PSBs by improving operational performance. Further banks have started liquidating non-core assets as another route to raise money.

- **NPA Resolution:** With RBI now providing directives to banks on resolution of NPAs, the process of cleaning up balance sheets has picked up pace. Further according to CRISIL, stressed assets in the banking system are unlikely to rise significantly over the medium term.

- **Promoter support:** The government has indicated unwavering support for PSBs and is seen to ensure so far that banks do not skip coupons on these bonds as such an event can impact the entire AT1 market and dent investor confidence.

- **Credit re-rating through consolidation:** The government has been hinting at more consolidation in the banking sector post the merger of SBI with its associates. Such an event can provide a chance of capital appreciation through credit re-rating to bond investors of a weaker bank if it merges with a stronger bank.

Not being in the nature of conventional debt instruments, AT1 bonds offer diversification under the fixed income umbrella. Regulator & promotor support around this market appears to be a comforting factor. Moreover, revival of the banking sector will attract more interest especially from the much dormant institutional investors like insurers, corporate treasuries, pension & provident funds. In an era of low interest rates, retail investors could spare a look at AT1 bonds as per the individual risk appetite and after sufficient due diligence. Conventional wisdom though demands a constant watch on the banking sector's performance as it is still not out of the woods.

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