

# AT1 bonds

Testing the boundaries of an equity-debt hybrid



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## A bond between viability and debt characteristics

The government on March 13 notified the Yes Bank Limited Reconstruction Scheme, 2020, prepared by the Reserve Bank of India (RBI).

Together with implementation of the scheme, Yes Bank has indicated that it will be writing down permanently and in full certain instruments qualifying as Additional Tier 1 (AT1) capital issued by it under the Basel III framework. However, common equity remains on the bank's books without any write-down.

While the decision is in line with the regulatory framework governing Basel III AT1 bonds, it seems contrary to conventional wisdom that bonds are generally senior to common equity. This has caused quite a stir in the credit market, with questions raised on the inherent risks in these instruments.

Before we come to all that, let us take a look at the quantum of Basel III AT1 instruments outstanding and their key features. As on December 31, 2019, around Rs 90,000 crore of such bonds were outstanding, of which close to 60% belonged to public sector banks and the rest to their private peers (*details in annexure 1*).

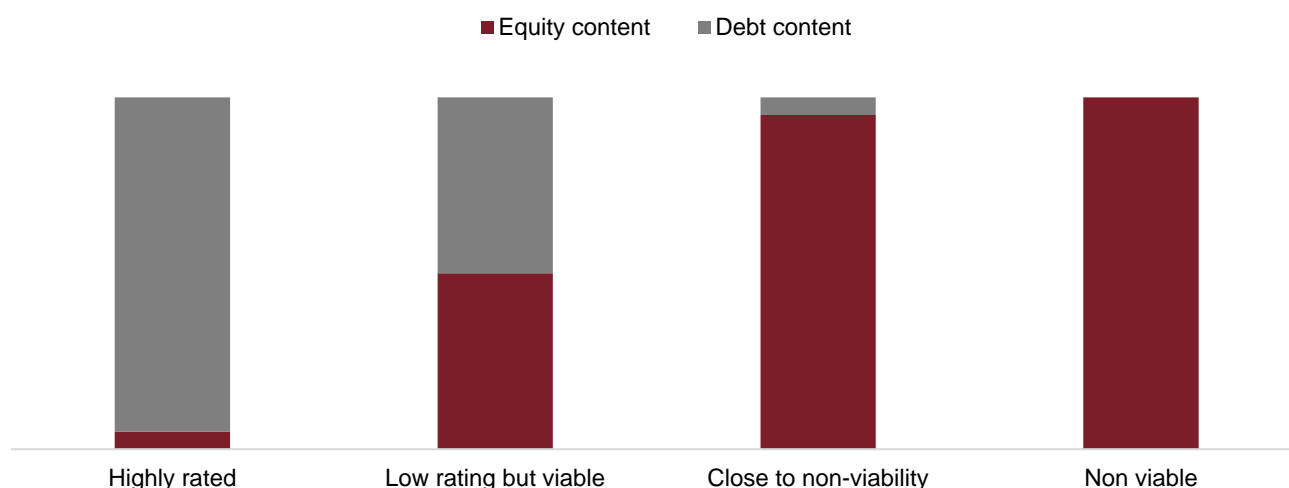
These bonds are hybrids with features of both equity and debt (*see box, Salient features of Basel III AT1 instruments*).

For weak banks, or those less viable ones such as Yes Bank, these instruments start behaving more like equity and less like debt. Hence, according to CRISIL's rating criteria, the notch-down for weak banks from the issuer rating could be substantial at three notches or more.

However, for a strong bank with high viability, Basel III AT1 instruments have more debt-like features and limited equity characteristics. In strong banks, there are likely to be limited risks to the servicing of coupons as well as exercise of call option to redeem these instruments. Thus, for banks rated at the higher end of the spectrum (AAA/AA+), it is more likely that the Basel III AT1 bonds will be rated one notch lower than the issuer credit rating (*refer to annexure 4 for details on the change in notch-down when rating levels change*).

The actual extent of notch-down depends on, besides the issuer rating, the expected adequacy of eligible reserves after capital conservation, and the cushion over regulatory required capital (*refer to annexures 2 and 3 for details on Basel III AT1 debt instruments rated by CRISIL*).

### As viability reduces, so do the debt-like characteristics of Basel III AT1 bonds



**Salient features of Basel III AT1 debt instruments**

The regulations under Basel III, framed post the Lehman crisis, are designed to enhance both the quantity and quality of capital held by banks. Compared with non-equity instruments qualifying as Tier 1 capital under Basel II, Basel III AT1 debt instruments have better loss-absorption features.

Basel III AT1 debt instruments are marked by

- a) Full coupon discretion
- b) High thresholds for likely coupon payment
- c) Principal loss absorption

This is in contrast to Basel II debt instruments, which are not subject to a principal loss absorption or write down. While both kinds of Basel III (AT1 and Tier-2) debt instruments have significant loss absorption features, AT1 bonds are designed to absorb losses on a going-concern basis. In other words, these are liable to be written down or converted to common equity at pre-specified trigger events or point of non-viability (PONV).

The **pre-specified trigger level** is linked to the Common Equity Tier 1 (CET1) of the bank – if it falls below 5.5% of risk weighted assets (RWA) before March 31, 2020, and below 6.125% of RWA on or after that date.

The **PONV trigger event** will be determined by the RBI at the point the bank becomes non-viable unless there is a write-off or conversion to equity of said Basel III AT1 bonds, or a public capital infusion happens. The regulation requires that the write-off or conversion occurs prior to any public sector injection of capital so that the capital provided by the public sector is not diluted.

## CRISIL's approach to rating Basel III AT1 debt instruments

Basel III AT1 bonds are perpetuals that pay a periodic coupon and can have a call option after a certain period once issuance has elapsed. Thus, the rating on the instrument essentially reflects the ability to service its coupon.

When a bank becomes non-viable, it is typically on the verge of default. Basel III AT1 bonds being converted to equity or being written down is usually a post-default event. Thus, whether the bonds are written down or converted to equity is immaterial as the rating captures only the probability of default.

Further, not exercising of the call option does not per se trigger default. However, inasmuch as being unable or unwilling to exercise the call option indicates a bank's weakening viability levels, it will constitute an element of the credit assessment and shall adequately be factored in its credit rating.

CRISIL typically rates Basel III AT I bonds issued by banks one to three notches below the issuer rating. The exact notch differential depends on its expectations on the following dimensions:

- I. Availability of eligible reserves, post capital conservation, and
- II. Cushion over regulatory capital requirements; and the bank's track record and management philosophy regarding these

On an exceptional basis, CRISIL may also assign a rating that is different from the notches mentioned. If the bank's metrics are weak enough to merit it, CRISIL will look at notch-down from issuer rating of more than three notches (*refer to article, 'Rating criteria for Basel III compliant non-equity capital instruments' published by CRISIL in 2017<sup>1</sup>*).

It is important to understand that risk levels of Basel III AT1 bonds are not only higher, but also change more rapidly than the issuer rating of banks – and this is reflected in their transition rates.

Thus, a one-notch change in the issuer rating can result in more than one-notch change in its Basel III AT1 bonds. In other words, the rating on the bonds will have sharper transitions compared with Basel III Tier 2 debt of a bank (*refer to annexure 4 for more details*).

## Bank hybrid defaults in domestic and global markets

Yes Bank's Basel III AT1 bond was the first one in India where the trigger for a write-down was tested.

It's pertinent to note that no CRISIL-rated AT1 instrument has defaulted in the past (*refer to annexures 2 and 3*)

But several public sectors banks have been close to breaching the trigger levels on their bonds. However, concerted efforts by the Reserve Bank of India (RBI) and the government have ensured that the bonds were serviced on time. This included relaxation of regulations, infusing funds and calling back the bonds. Such steps have built investor confidence in Basel III AT1 bonds.

The RBI has relaxed regulations to allow servicing of the Basel III AT1 bonds more than once. Many public sector banks were close to breaching the regulatory requirement to service coupon on their AT1 bonds. In January 2016, the RBI allowed all banks to service coupon from revenue reserves or past profits if current profits were not sufficient

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<sup>1</sup> [https://crisil.com/Ratings/Brochureware/RR\\_ASSES/BASEL\\_III\\_compliant\\_instruments.pdf](https://crisil.com/Ratings/Brochureware/RR_ASSES/BASEL_III_compliant_instruments.pdf)

to do so, subject to the bank meeting minimum capital requirements. Similarly, in February 2017, the RBI allowed banks to tap into other reserves, including statutory reserves. With these relaxations, almost all reserves barring a few<sup>2</sup> have been included as other distributable reserves for the purpose of servicing coupon on Basel III AT1 bonds.

Since the quantum of reserves available to service coupon increases, it significantly reduces the risk of non-servicing of coupon on AT1 bonds. After the 2017 revision, CRISIL estimated that the reserves available with public sector banks to service the coupon has nearly doubled (*refer to article published by CRISIL on February 3, 2017: RBI revises AT1 bonds rules to ease the pressure on banks*)<sup>3</sup>.

The changes so effected were through the RBI's circulars and hence were structural in nature.

In addition to effecting such structural changes, the RBI has also given one-time relaxations such as allowing the losses to be set off against share premium reserves, which are not part of distributable reserves.

The government, as the majority owner of the public sector banks, infused funds to restore capital levels, thereby enabling servicing of coupon on Basel III AT1 bonds. Between fiscals 2017 and 2019, the government of India infused close to Rs 2.20 lakh crore in public sector banks. This period saw over Rs 20,000 crore of Basel III AT1 bonds issued by public sector banks under prompt corrective action (PCA) being called back. In banks under PCA, CRISIL rated the Basel III AT1 bonds 3-5 notches lower than Basel III Tier-2 bonds (*refer to annexure 3*).

There have been instances of international banks writing off their Basel III AT1 instruments or stopping payment of coupons on them.

In 2019, Bank of Jinzhou cancelled dividends on its offshore preference shares for one year, pursuant to a drop in capital adequacy below regulatory norms as on December 31, 2018. Also, in 2017, Banco Popular's AT1 bonds worth €1.25 billion were written off as it reached multiple trigger points.

In the Indian context, however, we have seen defaults on other bank hybrid instruments. In August 2016, Dhanlaxmi Bank defaulted on coupon payments on its Upper Tier 2 bonds (issued under Basel II) as it reported regulated capital adequacy ratio (CAR) below 9%. The default followed a directive from the RBI that its capital adequacy had dipped below the regulatory minimum. However, it should be noted that Basel II debt instruments do not carry a principal loss absorption feature and hence were not written down.

On its part, Yes Bank was unable to raise capital from investors on time. It was also unable to service the coupon on Basel II Tier 1 bonds due on March 5, 2020. This was subject to the bank meeting the regulatory CAR. The coupon payment on these bonds also required prior approval of the RBI in case such payment resulted in an increase in net loss.

This is the reason the reconstruction scheme was notified under Section 45 of the Bank Regulation Act, 1949, which deems non-viability, or approaching non-viability. Subsequently, Yes Bank has indicated that it will be writing down these bonds permanently and in full, as per the regulatory framework governing Basel III AT1 bonds.

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<sup>2</sup> Reserves currently excluded are share premium account; revaluation reserves; foreign exchange translation reserves; investment reserves and reserves created on amalgamation.

<sup>3</sup> <https://www.crisil.com/content/dam/crisil/pr/press-release/2017/02/RBI-revises-AT1-bonds-rules-to-ease-the-pressure-on-banks.pdf>

## What next for Basel III AT1 bond investors

To be fair, Basel III AT1 bonds are complex financial instruments for investors. They have fairly high debt component at higher rating levels, and more equity-like characteristics at the lower end of the rating spectrum. The price of AT1 bonds may have a non-linear relationship with the rating, which means a notch change in rating could spawn a bigger change in yield on AT1 bonds compared with simpler instruments.

Investors should be aware of the risks inherent in Basel III AT1 bonds (which are higher than in Basel III Tier 2 bonds) and price them accordingly. The difference in yield of Basel III AT1 bonds over Basel III Tier 2 bonds at the time of issuance was around 130 bps<sup>4</sup>. Whether this premium sufficiently factors in the additional risks associated with Basel III AT1 bonds is a moot point.

Further, risks associated with Basel III AT1 bonds vary considerably and the premium can increase during periods of increase in market wide credit risk perception. Underscoring the point, the Bank of International Settlements, in its working paper No. 831<sup>5</sup>, for bail-in bonds (AT1 bonds) has highlighted, “*the premium varies pro-cyclically: a decline in market-wide credit risk lowers the bail-in risk premium for all banks, with the compression much stronger for riskier issuers. Banks, in turn, time their bail-in bond issuance to take advantage of periods of low premiums.*”

Besides, the perception that the government will step in to help service coupons of public sector banks may affect the yields on their Basel III AT1 instruments differentially compared with their private sector counterparts.

Investors could now re-check whether the bonds have been priced correctly, given the risks that have played out on these complex instruments.

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<sup>4</sup> Source: Prime Database; based on past three years data.

<sup>5</sup> Source: <https://www.bis.org/publ/work831.pdf>

## Annexures

### 1

#### Quantum of Basel III AT1 bonds outstanding as on December 31, 2019

Item	Basel III AT1 bonds outstanding (Rs crore) <sup>6</sup>
Public sector banks	53,389
Private sector banks (excluding Yes Bank)	28,610
Yes Bank	8,695
<b>Total</b>	<b>90,694</b>

### 2

#### CRISIL rating notch difference for Basel III AT1 instruments outstanding

Bank name	Rating of Tier II bonds (under Basel II and III) / infra Bonds	Rating of Basel III AT1 bonds	Quantum of Basel III AT1 outstanding rated by CRISIL (Rs crore)	Notch difference in rating
Andhra Bank	CRISIL AA+/RWDI	CRISIL AA- /RWDI	1,900	2
Axis Bank	CRISIL AAA/Stable	CRISIL AA+/Stable	7,000	1
Bank of Baroda	CRISIL AAA/Stable	CRISIL AA+/Negative	4,850	1
Canara Bank	CRISIL AAA/RWDI	CRISIL AA/RWDI	2,500	2
HDFC Bank	CRISIL AAA/Stable	CRISIL AA+/Stable	1,5000	1
ICICI Bank	CRISIL AAA/Stable	CRISIL AA+/Stable	4,500	1
Indian Bank	CRISIL AAA/RWDI	CRISIL AA+/RWDI	1,000	1
IndusInd Bank	CRISIL AA+/Stable	CRISIL AA/Stable	4,000	1
Punjab National Bank	CRISIL AA+/RWDI	CRISIL AA- /RWDI	3,000	2
State Bank of India	CRISIL AAA/Stable	CRISIL AA+/Stable	17,100	1
<b>Total</b>			<b>60,850</b>	

RWDI: Rating Watch with Developing Implications

At the higher end of the rating spectrum, the difference in rating of Basel III Tier 2 and Basel III AT1 is low, and gradually increases as the rating goes down.

Note that at the same issuer rating, the AT1 may have different notch-downs for different issuers. This is based on the availability of eligible reserves, post capital conservation, for coupon payment and track record and philosophy towards maintaining cushion over regulatory minimum.

<sup>6</sup> CRISIL estimates based on publically available information



## 3

**CRISIL rating notch difference when Basel III AT1 instruments were withdrawn**

Bank	Date on which the Basel III AT1 debt instruments were withdrawn	Rating of Tier II bonds (Under Basel II and III)/ infra bonds	Rating of Basel III AT1 bonds when CRISIL's rating was withdrawn	Quantum of Basel III AT1 rated by CRISIL (Rs crore)	Notch difference in rating
Allahabad Bank	Feb 17, 2017	CRISIL AA-/Negative	CRISIL A-/Negative	1,000	3
Bank of Maharashtra	Aug 31, 2018	CRISIL A+/Stable	CRISIL BBB+/Negative	1,000	3
Bank of India	Aug 31, 2018	CRISIL AA+/Stable	CRISIL A+/Negative	2,500	3
Central Bank of India*	Mar 10, 2016	CRISIL AA-/Negative	CRISIL A-/Negative	1,435	2
Corporation Bank	Aug 30, 2018	CRISIL AA-/Negative	CRISIL A-/Negative	1,000	3
Dena Bank	Jan 11, 2019	CRISIL AA-/RWPI #	CRISIL A-/Negative	400	3
IDBI Bank Ltd	Nov 22, 2018	CRISIL A+/Stable	CRISIL BBB+/Negative	4,500	3
Syndicate Bank*	Mar 10, 2016	CRISIL AA+/Stable	CRISIL AA-/stable	1,000	2
UCO Bank	May 27, 2016	CRISIL AA-/Negative	CRISIL BBB/Negative	2,500	5
United Bank of India	Aug 31, 2018	CRISIL AA-/Stable	CRISIL BBB+/Negative	1,100	4
<b>Total</b>				<b>16,435</b>	

\*Basel III AT1 debt instruments were not placed

# RWPI: Rating Watch with Positive Implications

## 4

**Rating notch difference when CRISIL took action on March 10, 2016**

As shown below, as the issuer rating transitions downwards, the difference between issuer rating and Basel III AT1 widens.

Bank	Transition in the ratings of Tier II bonds (under Basel II and III)/ infra bonds		Transition in the ratings of Basel III AT1		Original notch difference C = A1- B1	Final notch difference D = A2 – B2
	A1	A2	B1	B2		
Corporation Bank	CRISIL AA+/Stable	CRISIL AA/Negative	CRISIL AA-/Stable	CRISIL A/Negative	2	3
Dena Bank	CRISIL AA+/Negative	CRISIL AA-/Negative	CRISIL AA-/Negative	CRISIL A-/Negative	2	3
IDBI Bank	CRISIL AA+/Negative	CRISIL AA/Negative	CRISIL AA-/Negative	CRISIL A/Negative	2	3
UCO Bank	CRISIL AA+/Negative	CRISIL AA/Negative	CRISIL A+/Negative	CRISIL A-/Negative	3	4

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