AT-1 Bonds

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Why in News

Recently, the **Reserve Bank of India (RBI)** has made a proposal to write-down Additional Tier-1 (AT-1) bonds as part of the **SBI-led restructuring package for Yes Bank.**

Key Points

- AT-1 bonds are a type of **unsecured, perpetual bonds** that banks issue to shore up their core capital base to meet the **Basel-III norms.**
- There are **two routes** through which these bonds can be acquired:
  - **Initial private placement offers** of AT-1 bonds by banks seeking to raise money.
  - **Secondary market buys** of already-traded AT-1 bonds.
- AT-1 bonds are like any other bonds issued by banks and companies, but pay a **slightly higher rate of interest** compared to other bonds.
- These bonds are also **listed and traded on the exchanges.** So, if an AT-1 bondholder needs money, he can sell it in the secondary market.
- Investors **cannot return these bonds** to the issuing bank and get the money. i.e there is **no put option available** to its holders.
- However, the issuing banks have the **option to recall AT-1 bonds** issued by them (termed call options that allow banks to redeem them after 5 or 10 years).
- Banks issuing AT-1 bonds can skip interest payouts for a particular year or even reduce the bonds' face value.
- AT-1 bonds are **regulated by RBI.** If the RBI feels that a bank needs a rescue, it can simply ask the bank to write off its outstanding AT-1 bonds without consulting its investors.

Basel-III Norms

- It is an international regulatory accord that introduced a set of reforms designed to improve the regulation, supervision and risk management within the banking sector, post 2008 financial crisis.
- Under the Basel-III norms, **banks were asked to maintain a certain minimum level of capital** and not lend all the money they receive from deposits.
- According to Basel-III norms banks' regulatory capital is divided **into Tier 1 and Tier 2,** while **Tier 1 is subdivided into Common Equity Tier-1 (CET-1) and Additional Tier-1 (AT-1) capital.**
- **Common Equity Tier 1 capital** includes equity instruments where returns are linked to the banks' performance and therefore the performance of the share price. They have no maturity.
- **Additional Tier-1 capital** are perpetual bonds which carry a fixed coupon payable annually from past or present profits of the bank.
- They have no maturity, and their dividends can be cancelled at any time.
- Together, CET and AT-1 are called Common Equity. Under Basel III norms, minimum requirement for Common Equity Capital has been defined.
- Tier 2 capital consists of unsecured subordinated debt with an original maturity of at least five years.
- According to the Basel norms, if minimum Tier-1 capital falls below 6%, it allows for a write-off of these bonds.

RBI's Regulations Over Banks

- In a situation where a bank faces severe losses leading to erosion of regulatory capital, the **RBI can decide** if the bank has reached a situation wherein it is no longer viable.
- The RBI can then activate a **Point of Non-Viability Trigger (PONV)** and **assume executive powers of the bank.**
- By doing so, the RBI can do whatever is required to get the bank on track, including **superseding the existing management, forcing the bank to raise additional capital and so on.**
- However, activating PONV is followed by a write down of the AT-1 bonds, as **determined by the RBI through the Banking Regulation Act, 1949.**