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AT1 Bonds: the new Financial Weapons of Mass Destruction?

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Credit Default Swaps (CDS) are financial derivatives that earned the notoriety of being characterized Financial Weapons of Mass Destruction in the aftermath of the 2007-8 financial crisis, which originated in the US. CDS is a kind of insurance against credit default. It was issued by insurers like AIG and other market participants, and bought by investment banks like Goldman Sachs, to protect their investment in subprime and other securities. Speculators too can buy the contract without holding the underlying security. When the financial crisis reached its climax, AIG nearly went down the Lehman Brothers route to bankruptcy thanks to its CDS exposure. It avoided Lehman's wretched fate with the US government's rescue, but it was a close call. At its peak, the total outstanding CDS contracts in the market was estimated at more than 60 trillion dollars, bearing no correlation to the underlying value of the securities it sought to protect. An implosion in the CDS market, given its size, could have sounded the death knell of the financial markets, hence the tag Financial Weapons of Mass Destruction for these swap contracts.

Since the winding down of the crisis days, CDS no longer attracts the same level of attention, though the market for the swaps continues to be active.

Basel Committee Standards

Prior to the crisis, the Basel Committee for Banking Supervision had published two accords for capital adequacy, the Basel I standards in 1988 and Basel II in 2004. Basel 1 was a simplistic approach. It painted all counterparties in a particular category with the same brush by assigning a uniform risk weightage. Emphasis was on credit risk. Basel II accord proposed a more risk sensitive approach towards capital adequacy measurement. It also introduced capital standards for operational risk and incorporated the market risk measures brought in, post the Basel I accord. The Basel II accord was an abysmal failure in addressing the systemic, liquidity, leverage and pro cyclical issues in the banking sector, which led to and exacerbated the financial crisis.

The Basel III Accord

The Basel Committee, learning from these lessons, introduced several measures including a leverage ratio that sought to constrain excess leverage in the banking system, and global liquidity standards, along with a framework to promote the conservation of capital and the build-up of adequate buffers above the minimum that can be drawn down in periods of stress.

A critical lesson learnt from the crisis was the need for an additional capital layer that can absorb losses on a going concern basis.

The earlier Basel accords had elements of such capital but they could not act as an effective layer for absorbing losses for the simple reason that they were structured to do that only on a “gone concern” basis i.e. in a liquidation scenario. Depositors would have to stand in a queue and wait for liquidation of the assets of their bank to recover their investments. Such a “forced sale” usually results in lesser valuation of assets and takes time.

AT1 Bonds a.k.a Perpetuals

Basel III accord therefore introduced a new instrument, the Additional Tier 1 (AT1) bond, to protect depositors of a bank on a “going concern” basis. The essential element of this instrument is the imposition of losses on its holders without the bank being liquidated, if the Common Equity Tier 1 (CET 1) ratio falls below a threshold level. The bonds are also known as perpetuals as they do not have a specific redemption date. To qualify as an AT1 bond, 14 criteria are specified by the Basel Committee, the following being noteworthy apart from the perpetual nature:

1) Callable at the initiative of the issuer only after a minimum period of five years. For exercise of a call option, a bank must receive prior supervisory approval
2) The bank must have full discretion at all times to cancel distributions/payments of coupon/dividends
3) Coupon/dividends must be paid out of distributable items
4) Principal loss absorption through either
    - Conversion to common shares at an objective pre-specified trigger point or
    - A write-down mechanism which allocates losses to the instrument at a pre-specified trigger point.

AT1 bonds are quasi equity instruments that seek to protect depositors through the loss absorption mechanism and discretion on coupons, while leaving investors in the bonds in high risk circumstances.

Why would an investor go for AT1 Bonds?

The answer can be summarized in a single word: yield.

Scenario in today's yield starved world:

US government 10 year Treasury	2.054 %
German 10 year Bunds	0.309%
Japanese 10 year Bonds	-0.015% (negative)
UK 10 year Gilts	0.997%

(as on 8th September 2017)

In comparison, AT1 bonds stand out, with bonds of top rated global banks offering around 5%.

Indian PSU banks yield to maturity on rupee perpetuals ranges between 8 pct and 12.5 pct. The investors in AT1 bonds are primarily institutional. Regulators generally discourage the small retail investor from this segment. It is the expectation that wholesale investors with "superior" credit risk and market risk assessment skills are better equipped to invest in such bonds.

Another perplexing factor in AT1 bonds: why would someone invest in a bond that does not ever repay its principal? The call option comes to the rescue here. Despite issuers being explicitly prohibited under the Basel standards from creating an expectation with investors that the call will be exercised, the markets expect banks to call the bonds at the end of 5 years and usually well capitalized banks oblige. Voila! A perpetual bond is now a very attractive short term instrument with a mouthwatering yield.

Are AT1 Bonds serving the purpose?

Earlier this year, Banco Popular of Spain faced mounting losses and a run on the bank by its depositors. In a deal orchestrated by the European Commission, the larger Spanish bank Santander, took over Banco Popular, while imposing a write-down on AT1 bond holders for nearly 2 billion Euros. In the rescue of the Italian bank Montei Dei Paschi, 4.5 billion euros were converted into ordinary shares, though retail investors were spared.

The recent instances broadly prove that AT1 bonds are working as intended, though some central banks question if the write-downs happened at the European banks only when the banks were on the verge of becoming a "gone concern".

The experience with weak public sector banks in India offers a study in contrast. The Indian government's apparent willingness to support its subsidiary banks through additional capital to prevent an AT1 bond write-down, is perhaps a reflection of its worries of a contagion risk to the banking system and its own credibility in the traditional role of a promoter.

Moral hazard

The regulator now requires banks to provide for 50% of outstanding secured loans as soon as a defaulter is referred to the National Company Law Tribunal (NCLT) under the Insolvency and Bankruptcy Code, and 100% if the defaulter goes into liquidation. PSU banks in India, with large problem loan exposures being referred to the NCLT for resolution, would therefore require significant amounts of additional capital in the near future to meet the standards for CET 1 ratio as per the Basel III accord. This ideally should happen through the write-down of AT1 bonds, unless the government continues to step in with its own capital infusion. Apart from fiscal constraints that the government faces, such large scale bail out of institutional holders who have been enjoying high returns on account of the risky nature of AT1 bonds, will entail a moral hazard. It also goes against the very raison d'etre of the AT1 bonds which entails holders absorbing losses. The US government bailout of Wall Street Banks during the financial crisis attracted scathing criticism that it was tantamount to private profits and socialized losses. In a developing country like India, a tax payer led bailout of institutional investors in AT1 bonds, may not be politically palatable.

The concerns around protection of the principal portion of the AT1 bonds apart, the risk of nonpayment of coupon remains. Basel standards allow coupon (interest) payment only from distributable reserves. Further loan loss provisioning by weak PSU banks could lead to reserves being wiped out and trigger a default on coupon payments. Capital infusion by the government can potentially bailout the principal portion of AT1 bonds but cannot support banks without reserves in meeting coupon payment obligations.

The next Financial WMD's?

A final word on the potential of AT1 bonds to wreak havoc in the global financial system from a systemic perspective. An AT1 bond write-down for institutional holders could very well trigger a run on the bank by retail depositors who may fear that they may be next in the line to take a hit. As long as the problem is localized as observed recently in Spain and Italy, there is no risk to the broader banking system. But en masse write offs of AT1 bonds at multiple banks in the event of a scenario like the last financial crisis is a real possibility. If depositors stampede to the exits, the inter connected banking system would again be at risk as witnessed during the dark days of 2007-8.

Governments, regulators and financial market participants can perhaps take comfort from the recent statement of Janet Yellen, the Chairperson of the Board of Governors of the US Federal reserve, that she does not foresee another financial crisis in our lifetime. Let's hope that she is right! Readers may however take note that she did appear to back track on her remarks in a subsequent testimony to the US Senate.