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The goose that laid the golden eggs

AT1 bonds have a cushion on both sides. They are affected only after either equity or debt has been impacted

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Illustration: Ajay Mohanty

There have been allegations of mis-selling of AT1 bonds in India and elsewhere. These bonds have been written off fully to resolve the stress of some issuers. The subscribers are seeking help from every possible source, including the police, regulators, and courts. With widespread discontent, the existence of these bonds that emerged as a lifeline for banks following the global financial crisis is threatened.

A real sector company typically funds its operations through equity and debt. Since equity carries higher returns commensurate with risks, it is the first asset class to be hit in the case of a financial stress. Debt ranks higher than equity in an insolvency resolution waterfall. A financial sector company has two additional sources of funds. The bulk of its resources come from customer deposits, which carry predetermined returns and involve no risk-taking. The other source is bonds, which, like equity, are perpetual but carry fixed returns similar to debt. The hierarchy of claims in descending orders of risks/returns is as follows: Equity, bonds, debt, and deposits. They accordingly appear in the opposite order in the resolution waterfall.

According to conventional wisdom, reinforced by global laws and practices, bonds are less risky than equity but carry better returns than debt. The Basel-III norms reiterate that the bonds are junior to all other debt, but senior to common equity of a bank. In times of stress, bonds are written off after equity is fully written off, or are paid after the debt is fully paid. They have a cushion on both sides; they can be hit only after either the equity or debt is fully hit. With a medium risk-return profile, they are a win-win for issuers and subscribers, and even regulators. Consequently, the share of bonds as a proportion of bank capital has been increasing over the years.

In India, banks regulated by the banking regulator issue bonds to meet the regulatory capital adequacy requirements. Reportedly, they raised about Rs 33,420 crore from investors through bonds in 2022-23, which is about four times the amount raised by them through equity. The banks issue bonds to investors and service them in accordance with regulations set by the securities regulator. Since the issuers are credible institutions and the issues are regulated by two regulators, investors felt comfortable investing in bonds until recently.

Yes Bank raised a total of Rs 8,415 crore through bonds in December 2016 and October 2017. Of this, mutual funds and insurance/ provident funds subscribed bonds worth Rs 3,122 crore and Rs 269.70 crore, respectively. Additionally, 1,346 high-net-worth individuals/ retail investors bought these bonds for Rs 679 crore in the secondary markets. However, the entire amount was written off as part of the resolution of Yes Bank, using the provision in a circular/ terms of issue. Since the bonds were written off after notification of the Yes Bank Reconstruction Scheme, the High Court set it aside. Both the write-off and setting it aside were ordered on technical grounds. The ball is now before the Supreme Court, which may finally determine the substantive issues.

A few such bonds have been written off overseas, such as the recent example of Credit Suisse’s $17 billion bond write-off as part of the takeover deal by UBS. The bond write-offs before writing off the equity have dented the confidence of investors and are likely to drain bonds as a source of capital for banks. In desperate rescue messages, several regulators, such as the European Central Bank and the Monetary Authority of Singapore, are reinforcing the fundamental principles of finance, emphasising equity is the first to absorb the loss, and thereafter bonds are written down only to the extent required.

This has brought to the fore three major concerns. First, it seems some regulators are trying to rewrite the fundamentals of finance. In their wisdom, bonds are riskier than equity, as they can write them off prior to writing off the latter. They are establishing an inverse relationship between risk and return and changing the order in the insolvency waterfall to bonds, equity, debt, and deposits. This is beyond the comprehension of markets, investors, and financial pundits alike. This has the potential to banish bonds from the market with severe consequences.

Second, the insolvency regimes have a hard-coded waterfall that places the claims in a hierarchy in order of their risks, with deposits at the top, with an aim to ward off systemic instability. Bonds could not be written off before equity, if there was a framework for insolvency resolution of financial service providers (FSPs), or if the Insolvency and Bankruptcy Code, 2016, was used to resolve the stress, as being used for DHFL. Adhoc approach to resolving the stress of FSPs does more harm than good to the financial system. A dedicated framework for the resolution of FSPs has been hanging fire for many years now.

Third, it is the securities regulator's primary duty to protect investors. While it has tried to protect individual investors by putting bonds beyond their reach at the issue stage, it does not address the issue fully. Investors may lose if they buy bonds in the secondary market or if a mutual fund invests money in bonds on their behalf. The Yes Bank write-off, coupled with notional maturity for valuation norms, has impacted the appetite of mutual funds for bonds.

The need for bonds is beyond doubt. The banking and the securities regulator need them to capitalise banks and provide investment options for investors. They must restore the precedence of bonds over equity in the interest of banks and investors. They must also not allow any product whose purpose and functionality are not comprehensible. The government should establish a framework for resolving stress of FSPs.

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