Bank Re-capitalisation and Bank AT1s – An Overview

Kumaresh Ramakrishnan
Head - Fixed Income

The Finance Minister on October 24, 2017 announced PSU Bank (PSB) recapitalization to the tune of INR 2.1 trillion. Of this, direct GoI infusion is expected to be INR 1.53 trillion with the remaining INR 0.58 trillion to be raised of fresh equity directly from markets, by respective banks. Following is a brief analysis on the likely benefits of this package to PSBs and the AT1 bond market.

Whether this quantum is expected to be adequate?

As per estimates made by Rating agencies and Research houses, the total quantum of capital required by PSBs for recapitalization was reckoned at INR 2.1 – 2.4 trillion, contingent on the book growth and asset quality dynamics. Given this context, the proposed package of INR 2.1 trillion, be infused into PSBs is substantial and is expected to be adequate.

What was the exact nature of the problem?

As at end June 2017, the total quantum of 'bad loans' as a percentage of the overall loans (advances) of the PSBs was reckoned at 12-13% (equal to INR 7.3 trillion), being the highest ever witnessed in the Indian Banking sector. The burden of non-performing loans exerted enormous pressure both on profitability and growth aspects of PSBs, since provisioning needed to be stepped up for the mounting bad loans.

Also the capital position of PSBs was weak, which was reflected in their Tier I capital of 9.59% of Risk Weighted Assets (RWA) as on June 30, 2017. The Basel-III stipulation as on March 31, 2019 is 9.5%, reflecting limited capital cushion over regulatory requirements.

How will bank recapitalization help PSBs?

Until now, PSBs in general were consistently losing market share to their private sector counterparts as they were unable to defend their share of incremental business on account of paucity of capital. Also, many of the PSBs were incurring losses and received limited GoI capitalization (only INR 0.7 trillion was budgeted to be infused into the Banks under the Indra-dhanush program over 4 years).

Hence shrinking their balance sheets was the only option in order to remain over Capital thresholds. Some estimates reckoned that incremental market share for private sector banks was as high as 80% while their overall share in total Indian Banking sector advances was only 27.5% as at March 2017.

With this substantial capital infusion, PSBs will be better equipped to defend their market share and now aim for some moderate growth. Also, PSBs may also be more open to taking aggressive haircuts and resolution on existing bad loans given the capital backing. We estimate approx. INR 1.1 -1.25 trillion would be utilized to increase provisions against existing bad loans with the balance (INR 0.85-1 trillion) to be used for growth capital.

What is the near to medium term outlook going forward?

We expect the bank recapitalization to put a floor on existing ratings for PSBs. In the near term, the outlook for a few of the larger PSBs may be revised to “Stable” from “Negative”. However, significant rating upgrades will remain elusive till the earnings profile improve, which is expected to remain under pressure till slippages from standard loans / restructured loans into Bad Loans reduce substantially and the resultant impact on elevated provisioning reduces.

What does this mean for PSBs in the long term?

The commentary supporting the bank recapitalization program has communicated that smaller / weaker banks are expected to get only subsistence capital, just adequate to meet their regulatory requirements while larger / stronger banks are likely to get higher allocation of the recapitalization program. If this were to materialize, in the long run there can be significant activity in terms of mergers in the PSU Banking space and consolidation of the industry could be the most likely outcome. However, we will need to wait for exact details which is expected only over the next 1-2 months.

Outlook on Perpetual bonds (AT1s) of PSBs – Yields and Pricing

Given this background, the market outlook on PSU AT1s is turning positive. We have been running good exposure on PSU AT1s in our various bond and credit funds in line with the scheme objectives and their respective credit orientation.

In general our exposures to PSU AT1 bonds have ranged from 12-15% in our various portfolios. We would like to emphasize however that we have focused on the higher and mid-tier rated AT1s and have not moved down the credit curve in trying to reach for yields.

Our steady exposure to PSU AT1s all along has been driven by our conviction that while PSUs have been losing incremental market share, they still account for close to 75% of the outstanding credit stock (advances) in the banking system. As such they remain a critical component of the credit delivery mechanism and remain indispensable for GDP growth in the medium term. As such, the recapitalization of the PSBs was imminent and was only a matter of timing in our view. *It is worth noting that till date even the lower rated highly stressed banks have not missed a single coupon payment even as they passed through the lowest point in the cycle.*

On an average the higher grade PSU AT1s have seen yields move lower by 20-25 bps, post the announcement. However, the real action has been in the mid segment of PSU AT1s, rated in the AA to A+ category. Even as AAA rated PSU corporate bonds and G secs have seen some marginal widening in yields by 2-4 bps in the last week, the mid-tier rated PSU AT1s have rallied by almost 85-100 bps. *All our portfolios holding PSU-AT1s have benefitted quite strongly as a result.*

It is worth noting that even post the recent rally, AA+ rated AT1s of PSBs still trade almost 50-80 bps over plain vanilla bonds of similar rated NBFCs. In the case of AA / AA- rated PSU AT1s, the spread over similar rated NBFC bonds is higher by almost 100 bps. Even after factoring in equity like characteristics of AT1s, we find the spreads to be higher, given the ownership structure and parentage of PSB AT1s and their strategic importance.

The supply pipeline for AT1s is also expected to moderate in the coming months as fresh common equity will also now be available to these banks. Few banks have already tapped the equity market successfully in recent weeks. Post the recap announcement, market acceptance for new AT1s is also increasing, as newer investors also approach this market.

We continue to retain a favorable outlook on bank AT1 in general and PSU AT1s in particular.