India unlocks demand for AT1s

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Indian banks are planning to test investor appetite for Additional Tier 1 bonds after their market regulator ditched a valuation rule that had caused the largest buyer base to stay away from the instruments.

The Securities and Exchange Board of India last week reversed a rule requiring mutual funds to value AT1 bonds, which typically have a perpetual maturity and call after five years, as though they had a 100-year maturity and said the valuation should be based on the yield to call instead.

The introduction of the 100-year valuation rule, announced in 2021 and implemented in staggered phases up to April 1 2023, had deterred mutual funds from buying AT1s because it made their mark-to-market valuations more volatile. Mutual funds' holdings of AT1s dropped to Rs21.2bn (US$252m) as of December 2023, down 92% from Rs250.6bn in January 2020, according to data from Crisil Market Intelligence and Analytics.

"Price volatility was a significant deterrent as pricing was completely disconnected with reality," said Rajeev Radhakrishnan, chief investment officer for fixed income at SBI Funds Management.

The yields on bank capital bonds soared 60bp–110bp in 2021 after Sebi introduced strict rules such as the 100-year valuation requirement and concentration metrics, effective from April 2021, which stated that no mutual fund should own more than 10% of a single issuer's Basel III AT1 and Tier 2 capital. Issuance of onshore AT1 bonds reached a four-year low of Rs163bn in the fiscal year to end-March 2024 compared with Rs344bn in FY 2023, according to Prime Database.

Sebi decided to reverse the 100-year valuation rule on the recommendation of the National Financial Reporting Authority, which argued that the valuation of AT1 bonds on a yield-to-call basis (adjusted with appropriate risk spreads) would be consistent with market practice, as AT1 bonds have "been observed to trade at or quote at prices closer to yield-to-call".

"Price volatility will now only be based on changes in the base curve or spread, and not because of the way you are valuing it," said Radhakrishnan.

Banks are now expected to be able to attract more demand for AT1s at lower yields, according to DCM bankers.

"**State Bank of India** and **Canara Bank** are expected to tap the market very soon as they are among the banks who have taken board approval earlier," said Venkatakrishnan Srinivasan, founder and managing partner at Rockfort Fincap. The lenders have approval to raise up to Rs250bn and Rs85bn respectively from a mix of AT1 and Tier 2 bonds.

"Following the success of SBI and Canara, banks such as Punjab National Bank, Bank of Baroda, Union Bank of India, Indian Bank, Axis Bank and ICICI Bank, which have board approvals in place, are likely to issue AT1 bonds to strengthen their capital base," Srinivasan said.

Liquidity back

Following the easing of rules, liquidity is expected to improve and the spread between the AT1 bonds and government bonds to narrow.

"The spread can tighten a bit for public-sector lenders by 20bp–30bp following the easing of valuation rules," said Pankaj Pathak, fund manager of fixed income at Quantum Asset Management. "Investors derive comfort if the bank is state-owned."

While early movers might benefit from favourable pricing, however, significant yield tightening is unlikely.

"Since April 1 of last year, capital gains from debt funds are taxed according to the investor's income bracket, which has slowed inflows into debt mutual funds," said Srinivasan at Rockfort Fincap.