Financial services risk insights

Perpetual bonds – Demystifying the enigma

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Background

A perpetual bond is a quasi-equity instrument, which does not have a fixed maturity and in fact can exist perpetually with no principal repayment but only a coupon interest payment. The payment of such coupon is, however, at the discretion of the issuer who may decide to not make coupon payments in the year in which it has incurred losses or does not have enough reserves to make such payments. Banks in India pay the coupon after meeting the common equity tier I, tier II capital and total capital requirement ratios. Additionally, they have the discretion to cancel the coupon payments without the Reserve Bank of India's (RBI) permission upon not meeting the requirements set by the regulator. This coupon rate on the perpetual bonds can be a fixed rate or a floating rate linked to an external benchmark.

Theoretically, the price of a perpetual bond is determined by dividing the coupon with the discounting rate. The discounting rate is the expected yield on such bonds.

Perpetual bonds often have a call option attached to it, which gives the issuer a right, but not an obligation, to buy back these bonds at a certain price that is predetermined at the time of issuing the bonds. While these bonds are designated as perpetual bonds, the investors may, however, liquidate investments in perpetual bonds by selling them off in the secondary market.

As per the Basel and the RBI regulations, these instruments are to be included within the ambit of additional tier I capital and are also colloquially referred to as AT-1 bonds.

History of perpetual bonds

Dutch Water Authority is widely believed to be the first entity to issue perpetual bonds around the globe. The instruments, carrying a 5% coupon rate, were issued sometime in the 1640s.

The British government also issued these instruments to fund its world war efforts. Perpetual bonds were issued by governments to get through rough times at multiple instances.

It might be worthwhile to add that the value of an asset in the 1600s was measured by its ability to generate income, given that the markets for assets were largely illiquid. Feudal lords had many a land to their credit, but it was the rental income from the land that determined their worth. Hence, perpetual bonds, or what were referred to as consols back in the day, were of interest given their income generating ability over perpetuity.

In India, these bonds were permitted to be issued post implementation of Basel III norms. Andhra Bank is the first public sector bank to issue perpetual bonds and Axis Bank is the first private bank to issue perpetual bonds in India in 2016.

Features of perpetual bonds

- They do not have fixed maturity.
- There is a coupon rate attached to these bonds. This coupon rate can be fixed or floating (linked to an external benchmark).
- They can be enabled with a step-up coupon as per a pre-determined schedule.
- They come with a call option, which gives the issuer the right to recall these bonds during its lifetime. However, as per the regulatory guidelines, the issuing institution is not allowed to exercise the call option for at least 10 years from the date of issue.
- They do not reserve the right to regular coupon payments unlike other bonds. This means that if an issuer is incurring losses or has insufficient reserves, the perpetual bondholder may lose out on the coupon payment. Additionally, this interest does not accumulate in the next year, making the investors ineligible to receive previous years' interest even if the issuer is making profits in the subsequent years.

Risks of perpetual bonds

- **Risk of write down/credit risk:** These instruments are subject to write down if the bank has reached the levels of point of non-viability (PONV) as per the RBI. It is the point where the bank faces acute losses leading to erosion of regulatory capital and may cease to be a going concern unless appropriate measures are taken, like capital infusion. In a stress event like the current pandemic, where the loan books of the banks are under moratorium, which may turn into NPAs thereby eroding the capital of the bank, it significantly increases the risk of write down.
- **Reinvestment risk:** It is mitigated during the call protection period of perpetual bonds. Once the call protection period expires the investors are exposed to reinvestment risk owing to the uncertainty surrounding the redemption of these bonds.
- **Interest rate risk:** Perpetual bonds could carry fixed or floating rate coupons. In case of fixed coupon bond, a higher interest rate in the market as compared to the coupon rate on the bond, leads to fall in the price of the bond due to low demand. This means that same coupon divided by lower price of the bond will give higher yields. In case of perpetual bonds with a floating rate, investors can earn higher coupon returns if the corresponding benchmark rate increases. The investors may not essentially realise the gains from the increase in the benchmark rate. This is because after the call protection period expires, the issuer may choose to exercise the call option if the coupon rate linked with benchmark rate is higher than prevailing market rates.
- **Inflation risk:** Inflation is an incessant risk, which affects the real return on an investment. The real return on a bond is the difference between the interest rate on the bond and inflation rate. If inflation rate increases, the real return reduces. This risk is higher in case of fixed coupon bond.

Best time to issue perpetual bonds

Banks in India and around the globe are facing a challenge in ensuring adherence to the capital adequacy norms, given the outbreak of the pandemic. Historically, banks have been facing such challenges during times of financial crisis. Loan moratoriums, less economic activity and less spending power in hands of the consumers, lead to stress on asset quality and subsequent NPAs. This in turn requires the bank to set aside capital for provisioning thus creating capital adequacy issues.

As per Basel III norms, banks are required to maintain 5.5% to risk weighted assets as common equity tier I capital, 2.5% of risk weighted assets as capital conservation buffer and 1.5% of risk weighted assets as additional tier I capital. Basel recognised that raising equity capital, while an ideal route for capital infusion may not always guarantee the success of the same, given that the external market conditions must be friendly for the fund raising to be effective. As a result, AT-1 bonds were provided as an option. Hence, the most appropriate time for issue of an AT-1 bond is essentially during stressful times.

Perpetual bonds available in India

- Andhra Bank issued perpetual bonds in tranches in 2014 and 2016. In 2014, the bank raised INR 500 crore by way of AT-1 bonds offering 9.55% coupon rate. During the same time, the 10-year government bond yield was around 7.85%. This shows a spread of almost 170 bps.
- In February 2016, Andhra bank raised INR 800 crore offering coupon rate of 10.95% and in August 2016 another INR 900 crore offering 10.99% coupon rate. During the corresponding time, the government yield was around 7.62% and 7.12%, respectively. The spread was around 333 bps and 387 bps.
- Axis Bank is the first private bank to issue perpetual bonds in June 2017 to the tune of INR 3500 crore offering a coupon rate of 8.75%. During this period the 10-year government yield was around 6.51% translating a spread of 224 bps.
- In July 2020, Bank of Baroda issued perpetual bonds to the tune of INR 764 crore offering a coupon rate of 8.25%. Shortly thereafter, the Bank raised another INR 981 crore by issue of AT1 bonds carrying a coupon rate of 8.5%. Both these issues were however on a private placement offer. The government yield for this period was around 5.85% translating to a spread of 240 to 265 bps.
- In September 2020, India's largest lender, State Bank of India raised around INR 4,000 crore by way of perpetual bonds offering a coupon of around 7.74%. This bond has a call protection period of five years. During this period, the government yield was around 6% translating a spread of 174 bps.
- In September 2020, Canara Bank has also raised INR 1,012 crore by issuing AT-1 bonds offering an interest of 8.3%. With 10 government yield around 6%, it translates a spread of 230 bps.
- HDFC Bank has also planned to issue perpetual bonds for its business expansion plans and improving its asset quality.
- Indian Bank is also planning to raise around INR 2,000 crore by way of AT-1 bonds in the December quarter.

An analysis of the above indicates that a strong bank is able to issue a perpetual bond at a far lower spread as is the case with the SBI with a spread from the risk free rate at 174 bps.

Inherent challenges of perpetual bonds

Allowing perpetual bonds to be categorised under the bucket of additional tier I capital is what created a big market for perpetual bonds. This facility was created by BASEL, the global central banking regulator, with an intent to provide an additional financing option for the banks. Thus, the product was never suitable for retail investors, given their lack of sophistication for such complex instruments. Thereby, SEBI has rightly barred retail investors from subscribing to the issue of AT-1 bonds and allowed only qualified institutional buyers (QIBs) by virtue of the SEBI guideline dated 6 October 2020 on the subject. However, mutual funds, being QIB's can invest in these bonds through their debt funds, thereby still exposing the retail investor of these funds to the risk of AT-1 bonds. It might be worthwhile for the SEBI to evaluate specific exclusion of AT-1 bonds from liquid debt funds and allow for their inclusion in balanced funds only.

Regulatory framework for perpetual bonds in India

To implement the Basel III capital regulations in India, the RBI allowed the use of perpetual debt instruments to be included in the additional tier I capital of banks. However, considering the complexity and the risk profile of the instrument, the RBI and SEBI have issued certain regulatory guidelines from time to time.

- In a circular dated 6 October 2020, the SEBI issued certain additional guidelines relating to the issuance, trading and listing of perpetual debt instruments or additional tier I capital.

  A summary of the guidelines issued is captured below:

  - The issue of these instruments must be done only on the electronic book provider (EBP) platform.
  - Only QIBs must be allowed to participate in the issuance.
  - The minimum allotment and trading size shall be INR 1 crore.
  - The conditions under which the call option will be exercised must be disclosed in the memorandum.
  - The issuer is also required to disclose audited financial statements of the firm as well as their debt-equity ratio before and after the issue.
  - All the risks inherent to the instrument, including the point of non-viability clause, must also be disclosed.
  - The changes in the framework by the SEBI is in the wake of the recent crisis at a certain private sector bank where the entire value of AT-1 bonds was written down. The move is also aimed at protecting interest of retail investors who may potentially have a limited understanding of the inherent risks of these instruments as well as their own rights and obligations. In 2015, the SEBI had issued a similar circular wherein the minimum trading size was set at INR 2 lakh.option at their own discretion. Prior approval from RBI is required.

- In a circular dated 2 February 2017, the RBI instructed that coupons on perpetual debt instruments must be paid out of current year profits or reserves if the bank meets the minimum regulatory capital requirements. This was an amendment to the master circular earlier issued in April 2013.

- As per the master circular dated 1 July 2015 on Basel III capital regulations:

  - Banks are barred from exercising the call option on these securities for a minimum of five years.
  - Additionally, they are required not to engage in any activity that could give an indication to the market that the bonds are about to be called.
  - Banks are also restricted from exercising the call option at their own discretion. Prior approval from RBI is required.
  - The issue document must clearly outline the events that could trigger PONV and hence could lead to a write-down.

- In a RBI notification, **Issue of rupee denominated bonds overseas** released on 3 November 2016, the RBI allowed banks to issue rupee denominated perpetual debt instruments in the overseas markets that qualify towards additional tier I capital. This effectively meant that banks in India could issue perpetual masala bonds.

Future of perpetual bonds

Going forward, the perpetual bond market is expected to grow deeper as these instruments start finding more and more takers due to the prevalence of low interest rates across the globe. However, this will not be without corresponding guidelines and regulations around market conduct.

In-line with the developed economies corporates in India might start looking at these bonds as a potential source of funding. The SEBI may consider coming up with specific instructions around the same especially around expected rating thresholds for corporates to have before considering this option as a potential source of funding.

We also see a possibility of the government exploring this funding option, especially given the fact that these instruments only impose an interest servicing obligation and not one of debt repayment. The beginning of this trend is visible by the proposal put forth by the Spanish government to EU to raise EUR 1.5 trillion through the issue of perpetual bonds. The economic slowdown across the world will further aid the growth of these instruments since it will help corporates gain access to long term funds at a relatively lower cost.

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6 Authors analysis based on understanding of perpetual bonds.

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