Indian Tier 2 issues surge

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India's public sector banks are rushing out domestic Tier 2 bonds for the second year in a row as they strive to meet Basel III requirements against a backdrop of poor profitability and lowered ratings.

PSBs issued Tier 2 bonds worth Rs272bn (US$4.08bn) in the financial year that ended in March, the highest in five years and more than four times the Rs63bn issued by private-sector banks, according to PRIME Database.

The current financial year has started on a strong note as well, with issuance of Rs30bn in April and May.

Last week, Oriental Bank of Commerce announced plans to raise up to Rs10bn from Tier 2 bonds. It received the lowest bid at 9.05% for 10-year bonds, according to market sources.

State-owned banks are ramping up Tier 2 bonds because other fundraising avenues are extremely constrained, due to low profitability and limited appetite among investors for Additional Tier 1 paper, said Vibha Batra, senior vice president at rating agency ICRA.

PSBs suffered cumulative losses in the second half of fiscal year 2016 that were more than double the government's capital injection for the year, heightening the need for more external capital, according to Fitch Ratings. The government injected Rs250bn into state-owned banks in FY16.

The core capital ratios of many PSBs are close to or below the Basel III minimum regulatory requirement of 8% which will come into force in 2019, Fitch Ratings notes.

PSBs will need to raise capital of Rs2.6trn between 2015 and 2019 to meet Basel III requirements, of which Rs1.7trn is expected to be Tier 1 capital and the remainder can be raised as Tier 2, said Krishnan Sitaraman, senior director at Crisil Ratings.

ICRA anticipates an even higher requirement for Tier 2 capital of Rs1.2trn to Rs1.5trn between FY17 and FY19.

Legacy bonds

Banks must also replace legacy bonds making up anywhere between 30% and 80% of their current Tier 2 capital, according to S&P.

“Major demand for these bonds will be driven by the replacement of legacy Tier 2 bonds on the banks' balance sheets by Basel III compliant Tier 2 bonds,” said Amit Pandey from S&P Global Ratings.

In the past year, banks have begun replacing these legacy instruments with Basel III-compliant Tier 2 bonds, which include a loss-absorption trigger at the point of non-viability. The legacy T2 instruments lose capital content progressively every year. Many have maturity or call options from 2016-19, added Pandey from S&P.

Global and local rating agencies have downgraded a slew of public sector banks in the past few months due to limited earnings visibility, adding a further hurdle to their recapitalisation efforts.

Banks with lower credit profiles will find it difficult to raise money from Tier 2 bonds, ICRA’s Batra said.

The credit spreads of existing Tier 2 bonds against 10-year government securities have widened by 20bp-30bp since January, after the RBI ordered banks to restate their bad loans. However, yields on government securities declined over the period, leaving all-in yields less impacted.

On the buyside, there is good demand from insurance companies, retirement funds, mutual funds, high-net-worth individuals and even foreign institutional investors for AA and AAA rated Tier 2 bonds of state-owned banks, which they tend to hold to maturity.

According to S&P’s Pandey, more than a third of Tier 2 issuance in the past six months came from State Bank of India, which has domestic Triple A ratings for these bonds.