Indian Economy · GS - III

Explain the role of Additional Tier-1 bonds in strengthening the banking system. Discuss the risks associated with these instruments and the need for investor protection.

EXAM YEAR	PAPER	SUBJECT
DAILY PRACTICE 20/10/2026	GS - III	Indian Economy

MARKS	WORD LIMIT
10	~150 words

Answer Hint

Basel III norms, regulatory capital, perpetual bonds, loss-absorption mechanism, banking stability, Yes Bank crisis, investor awareness, financial regulation, risk disclosure.

Model Answer

Introduction

Additional Tier-1 (AT-1) bonds are financial instruments issued by banks to strengthen their regulatory capital. Under Basel III norms, they help banks absorb losses and improve resilience during financial stress.

Role in Banking Stability

AT-1 bonds provide banks with an additional source of capital without immediate dilution of existing shareholders' ownership. Their loss-absorption features can help protect depositors and reduce pressure on public funds during banking crises.

Risks Associated with AT-1 Bonds

- **Perpetual nature:** These instruments generally have no fixed maturity date.
- **Loss of principal:** Their value may be written down or converted into equity under specified conditions.
- **Interest uncertainty:** Banks may cancel coupon payments under applicable terms.

- **Limited liquidity:** Investors may face difficulty selling these bonds at a fair price.
- **Complexity:** Retail investors may underestimate the risks when focusing mainly on advertised returns.

The Yes Bank crisis highlighted the potential consequences for investors when AT-1 bonds are written down during a banking resolution.

Way Forward

Regulators should ensure clear risk disclosures, appropriate distribution practices and investor awareness. Investors should assess the issuer's financial health, understand loss-absorption provisions and avoid treating AT-1 bonds as substitutes for guaranteed deposits.

Conclusion

AT-1 bonds can strengthen bank capital and financial stability, but their effectiveness depends on sound regulation and informed investment decisions. Transparency and proper risk assessment are essential to balance banking resilience with investor protection.

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