The Cost of a Yes to a Bank Rescue act*

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The revival package announced by the Reserve Bank of India (RBI) to rescue insolvent Yes Bank smacks of desperation. Having placed a moratorium on the bank's activities and capping withdrawals by depositors at Rs 50,000, the government has called upon the State Bank of India (SBI), to lead the rescue. The SBI, which has its own share of problems to resolve, has responded with alacrity. Even before undertaking due diligence, SBI Chairman Rajnish Kumar has announced that his bank is willing to outlay as much as Rs 10,000 crore to recapitalise ailing Yes Bank and restore it to health. There is little doubt that the SBI is merely acting on the government's bidding.

The SBI 'lifeline'

It is telling that the RBI, which has drafted the "Yes Bank Ltd Reconstruction Scheme, 2020", has made the SBI the anchor investor in Yes Bank equity, paying a premium of at least Rs 8 on a share with face value of Rs 2, and purchasing as many shares as needed to acquire a 49% stake. Simultaneously, the authorised capital of Yes Bank is to be raised from Rs 800 crore to Rs 5,000 crore. So, to start with, the SBI would be investing Rs 2,450 crore to become the dominant stakeholder. But that is only the beginning. In his statement to reporters, declaring ownership of the RBI's plan, Mr. Kumar said that he has set his bank an investment boundary of Rs 10,000 crore, with the amount actually invested depending on how much money is needed to keep Yes Bank afloat. His assumption is that Yes Bank would need about Rs 20,000 crore, and at the valuation of Rs 10 a share, that would require an investment of Rs 9,800 crore from the SBI for it to keep its stake at 49%.

This is a big ask of the SBI by the government, which clearly believes there is too much at stake. There are depositors big and small involved who were attracted by the higher interest rate offered by private banks like Yes Bank and who would lose hugely if Yes Bank is allowed to collapse. That would, besides making the government unpopular, most likely set off a chain of withdrawals from other private banks as well as some weaker public banks, with the contagion posing a systemic threat. Fearing that outcome, the Finance Minister and the Chief Economic Adviser have been straining their vocal cords to persuade depositors that their money is safe and that they should not be misled by rumours to the contrary.

Possible economic reaction

Moreover, firms and agents dependent on Yes Bank for credit to keep them in business may find their operations disrupted and new credit lines difficult to find. That could lead to their defaulting on debt they owe other creditors. There would also be adverse spin-off effects on investors in bonds and instruments issued by Yes Bank, triggering turmoil in other parts of the financial system. Not surprisingly, Mr. Kumar justifies the SBI's action on the grounds that Yes Bank cannot be allowed to fail since that "would have consequences for the Indian economy". That danger arises because the intervention has been much delayed. There have been reports of governance failures, accounting irregularities and balance sheet weaknesses at Yes Bank for more than two years now. It is because of the delay that escalated intervention is unavoidable.

The main planks

But is the SBI's intervention likely to succeed. The RBI's restructuring plan seems to be based on three principles. The first is that the government is not expected to directly invest in Yes Bank, perhaps because that would overburden its already strained finances, weakened further by a spate of recent tax concessions. The second is that Yes Bank is not to be merged with the SBI, but become a standalone subsidiary, equity in which could be sold on a later date if that proves feasible and the SBI so desires. Third, investors other than the SBI must play an important role in the revival of Yes Bank, since the equity of the bank is expected to rise from Rs 800 crore to anywhere between Rs 5,000 crore and Rs 20,000 crore, with the SBI holding only 49% of the total. So the SBI's role is not limited to immediately infusing capital into the damaged bank but also involves building investor confidence in the future of the bank through its dominant presence. Mr. Kumar claims that more than 20 potential investors have approached the SBI to join in the resuscitation effort.

Confidence is crucial, because in the absence of investor support the success of the restructuring exercise is not guaranteed. In fact, it is not clear as yet whether even Rs 20,000 crore is enough to restore Yes Bank to health. What emerges from the available evidence is that Yes Bank had ramped up its lending in recent years, with gross advances doubling from a little less than Rs 1 lakh crore at end of financial year 2015-16, to around Rs 205,000 crore (or more than double) at the end of 2017-18 and about Rs 245,000 crore at the end of 2018-19. According to reports, the bank's exposure to bankrupt or heavily indebted corporate groups such as Dewan Housing Finance Corporation Ltd. (DHFL), Reliance Anil Dhirubhai Ambani Group (ADAG), Infrastructure Leasing & Financial Services Limited (IL&FS) and Essel, besides the now stressed Vodafone, is substantial. This suggests that in search of high returns, the bank was engaged in risky leveraged lending or lending to already heavily indebted targets. This could make the asking sum to restore health much larger than initially estimated.

The RBI has implicitly provided for this possibility in its restructuring plan. It has announced that additional tier 1 bonds (AT1 bonds) issued by Yes, totalling close to Rs 11,000 crore, "shall stand written down permanently, in full, with effect from the appointed date". AT1 bonds offer investors a higher return because of the higher risk associated with them, including the possibility of being written down when a bank's equity base is under threat. But investors, who bought into these bonds because of a thirst for higher yields are likely to approach the courts, hampering the restructuring process. Overall, given uncertainties of this kind and the gloomy economic climate, investors may not be willing to outlay large sums on equity of a shaky bank.

The approach and flaws

Meanwhile, narrow explanations are on offer to explain the crisis. Investigations into the dealings of Yes Bank co-founder Rana Kapoor point to quid pro quo payments to family-controlled shell companies in return for large loans to entities such as DHFL, which were already stressed. But there is more to the crisis than just corruption. The government has been promoting a strategy in which growth is driven by a credit splurge, and large loans to shaky corporates are condoned or even encouraged, in the hope that they would drive investment. To that end bankers were offered a free run or even encouraged to do the wrong thing. This did raise investment levels, but very often in projects that were financially unviable. Such an environment also provided fertile ground for rogue bankers and felonious borrowers, resulting in large non-performing assets that must be written off. As of now, the SBI is providing the finances, but if the RBI's scheme does not work and that investment is not recovered, the SBI's stakeholders — the government and tax payers — must finally foot the bill.

*** This article was originally published in The Hindu on March 10, 2020.**