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As Yes Bank unravels, a look at its previous audited financial statements for clues

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When IDBI Bank's non-performing assets touched 29% with resultant erosion in capital, the government quietly organized a takeover by the Life Insurance Corporation of India. Shareholders, depositors/bond investors and holders of hybrid instruments (which rank between equity and bonds) did not lose money or face a write down. The financial markets shrugged away the deal. A public sector bank being rescued by a public sector life insurer, was a nonevent.

In contrast, Yes Bank's rescue orchestrated by India's largest bank, State Bank of India, with blessings of the government, preceded by a moratorium on the bank on 5 March 2020, created shock and awe in the financial markets, threw depositors into a tizzy on account of partial restrictions on withdrawal, impacted payment systems relying on Yes Bank, resulted in market losses for equity shareholders and led to the ultimate nightmarish scenario of a 100% prospective loss for holders of hybrid instruments, the Additional Tier 1 bonds.

The issues faced by Yes Bank have been in the public domain for a while, starting with divergence in asset classification compared to RBI's norms, governance issues, whistleblower complaints, denial of the promoter/CEO's extension etc. While its stock price cratered from a yearly high of Rs 285 to Rs 36 before the rescue, many depositors (though not all) and AT1 Bond holders were lulled into complacency as the problems were festering for a while without any overt panic.

Prompt corrective action framework

Strangely, the bank was not brought under the RBI's Prompt Corrective Action (PCA) framework. In line with the Basel Committee's recommendations, the banking regulator in India, RBI, has put in place an early warning mechanism for banks, the PCA framework. Yes Bank's collapse without going through PCA first, does not show the regulator in a good light. Merely relying on technicalities/ratios which are largely dependent on the bank management's timely recognition of problem loans as NPA's, will not help. Yes Bank's case would call for a

review of the current PCA mechanism. Perhaps depositors and investors would have acted differently if the bank had been brought under PCA.

It is therefore worthwhile to examine the bank's Annual Report/audited financial statements for the last two years, to see if investors could have discerned some clues which would have been a harbinger of the sudden descent of the bank into moratorium and administration.

A marketing document

Yes Bank's latest available Annual Report for 2018-19 proudly show cases various awards it had bagged, and claimed to have emerged as the national champion for "governance and financial excellence". It proclaimed that it was poised to be the "cutting edge digital bank in India".

Its corporate banking business segment, which has since turned out to be the primary reason for the bank's downfall, claimed that it "prioritized credit quality and all offerings were made following a rigorous analysis of the client's risk profile, as well as proactive monitoring of credit, market and operational risks". The bank was built on its "robust risk management system".

The audited financial statements as on 31.3.2019 indicated that the Gross NPA% and Net NPA%, the most widely watched measures for the banking industry were "3.22%" and "1.86%", significantly better when compared to its ultimate rescuer State Bank of India's figures at 6.94% and 2.65% respectively. Common Tier 1 capital adequacy ratio (CET1) was at "8.4%" against a mandated 7.375%. Subsequently, the Gross NPA% and Net NPA% more than doubled at the end of 30.09.2019, but the levels, as per the audited statements, were less than the banking industry's average. Capital adequacy ratio as on 30.09.2019, was at "16.3%", well above the regulator's requirement of 10.875%.

No pointers on festering NPA's

The Annual Report for 2018-19 stated that there were no disclosure requirements under the RBI regulations on disclosures of divergences in asset classification and provisioning, pursuant to the conclusion of its FY 2017-18 RBI Annual Supervisory Process.

On 14 March 2020, when the December 2019 quarter's results were published soon after the bank being placed under administration and a moratorium, they revealed a shocking state of affairs. The Gross NPA% shot up to a whopping 18.87%, losses amounted to Rs 18,564 cr, and capital was all but wiped off, with CET1 ratio at 0.6%.

The results boil down primarily to one factor: a sudden increase in non-performing assets. Did NPA's treble in just one quarter, or did the bank finally recognize the long standing problem loans, reclassify them, and make provisions for them? Why was NPA classification delayed, were the regulator and the auditor mute spectators when the bank's management did not recognize them earlier? These questions are all the more troubling as the

bank's problem loan accounts pertaining to large corporate borrowers, have been bandied about in the public domain.

To be fair, one also wonders if this was a "big bath" strategy, in which new management, wishing to wipe the slate clean and start anew, makes humongous provisions for bad loans at one go, by enhancing provision coverage ratio as well as recognizing stressed loans as NPA's, hitherto classified as standard loans.

Corporate governance

The latest Annual report for 2018-19 declares that the Corporate Governance Structure of the Bank, "provides a comprehensive framework to (i) enhance accountability to shareholders and other stakeholders, (ii) ensure timely implementations of the plans and accurate disclosures of all material matters, (iii) deal fairly with shareholders and other stakeholder interests, and (iv) maintain high standards of business ethics and integrity".

According to the previous Annual Report for 2017-18, when the promoter was still at the helm, "there were no materially significant transactions with related parties including promoters, directors, key managerial personnel, subsidiaries or relatives of the Directors during the financial year which could lead to a potential conflict with the interest between the Bank and these parties".

Cut over to March 2020, and we have reports of the Enforcement Directorate, functioning under the Ministry of Finance arresting the bank's founder for alleged money laundering offences and kickbacks to the promoter. In an egregious deal being investigated by the CBI, a prime property offered as a collateral to the bank by a stressed borrower, was released, and then allegedly purchased by a related party of the bank's founder at below market prices. If these allegations are proven in a court of law that would indeed mark a new low for India's banking industry already reeling under non-performing assets, partly on account of promoters of defaulting corporate borrowers, treating the company as their personal piggy bank through related party transactions; and now we have an instance of a bank's promoter allegedly flouting basic corporate governance standards for related party transactions, for his personal benefit.

Perhaps the flawed organizational structure of the bank's Chief Risk Officer reporting to the MD and CEO contributed to the malaise; not that reporting to the Board would have helped much. Rarely have board members in the Indian corporate world, demonstrated courage in standing up for small shareholders and in this case depositors, when faced with dubious investment/credit proposals floated by the promoter/CEO.

Credit rating

Non-Convertible, Redeemable, Unsecured, BASEL III compliant Tier II Bonds of the bank, were rated "**AAA"** at the time of issue. The stellar track record of the rating agencies speak for themselves.

Lesson for investors

Financial statements often hide more than what they reveal. Extreme cases like Enron and Satyam are well known.

Asset quality as represented by Gross NPA% and Net NPA%, is the main indicator of the health of a bank, in addition to the unpublished Special Mention Account figures. Banks move heaven and earth to postpone recognition of NPA's. It often becomes a cat and mouse game between the bank's management and auditors/bank supervisors. The divergence between a bank's own asset classification and that of the banking supervisor, as published in financial statements, demonstrate this. But even this disclosure is likely to be only the tip of the iceberg.

Investors should take the published numbers with a pinch of salt, and rely on "market intelligence" as well. Some may dismiss this with disdain as mere gossip and rumour and claim to take decisions only on data. But in Yes Bank's case, the market it appears, knew much more than the "independent" Board, regulators and auditors, or at least, what they cared to admit. As to our inimitable credit rating agencies, not much can come between them and the award of rosy "AAA" or "AA" ratings for their large fee paying customers.

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