Riskier than Equity

- Case study of AT1 write-down of Yes Bank Limited

By Manick Wadhwa and Anivesh Bharadwaj[1]

Abstract

Owing to its deteriorating financial position, Yes Bank, one of India's largest private banks, wrote down INR 8,415 crore worth of its Additional Tier 1 ("AT1") Bonds in March 2020. Basel III complaint AT1 Bonds have regularly been issued by Banks in India. These bonds act as buffers for banks in times of stress and are perceived to safer than equity shares of a bank. The write-down of Yes Bank's AT1, however, was done without first writing-down of common equity of the Bank, which held an inferior position to the AT 1 Bonds.

In this paper, we critically examine the legal provisions and implications relating to write-down of AT1 Bonds in India and whether the write-down in case of Yes Bank was in accordance with the public policy and the terms of contract entered with the Bondholders. Two-years on, with the Yes Bank case study we also attempt to examine the role and impact of RBI in creating a security riskier than common equity.

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[1] Mr. Manick Wadhwa works as the Director of Strategy with a New Delhi based Investment Bank. He is lawyer by qualification and is a member of CFA Institute, USA.
Mr. Anivesh Bharadwaj is a Visiting Research Scholar at the Columbia Law School and was previously working at International Criminal Court as a Visiting Professional. He is also a qualified and registered advocate in India, practicing across legal fora.

"*When confidence goes, it goes.*"

- Hank Paulson, Former US Treasury Secretary

Background

Yes Bank Limited (**"the Bank/YBL"**), one of India's largest private banks, had been under stress for a few months, marred by low capital adequacy and asset quality issues. In FY 2019-20, the Bank saw a significant decline in its deposit base and an increase in its NPA ratios, resulting in a breach of various statutory ratios by the Bank. Further, the Bank had also breached the RBI mandated Common Equity (CET1) ratio and Tier 1 capital ratio which, in March 2020, stood at 6.3%.and 6.5% as compared to the minimum requirements of 7.375% and 8.875% respectively.

The Central Government placed the Bank under a moratorium on 5 March 2020, owing to its depleting financial health.[2] Immediately after which, RBI took over the board of the Bank[3] and proposed a Draft Reconstruction Scheme on 6 March 2020 proposing to, simpliciter, write off the Additional Tier 1 Bonds **("AT1 Bonds")**.[4]

Accordingly, on 13 March 2020, Government of India, after making certain vital changes to the scheme, *inter alia* removing the clause that permitted the write-off of AT1 Bonds, notified the 'Yes Bank Ltd. Reconstruction Scheme, 2020' (**"Reconstruction Scheme"**) with the objective of protecting the interest of depositors and providing stability to Yes Bank as well as to the entire financial system.[5]

On 14th March 2020, Yes Bank issued a statement disclosing that it had fully and permanently written down two of its AT1 Bonds worth INR 8,415 crore, thereby extinguishing the value of the same (**"Write-down Disclosure"**).

The Bank, in the last six years, had issued three Basel III Compliant AT I Bonds, to the tune of INR 8,695 crores, to meet its capital adequacy requirements.[6] AT1 Bonds have been regularly issued by Banks in India. These AT1 bonds act as buffers for banks in times of stress; hence, they are quasi-equity in nature. The AT1 bonds are perpetual, i.e., with no maturity, however with a call option after five years. AT1 Bonds are part of 'Schedule 4 – Borrowings' in the Balance Sheet of the bank and are considered as liabilities in the Balance Sheet of the bank.

Issues with the write-down of Yes Bank's AT1 Bonds

1. **Write down of the AT1 Bonds was not done as per the order specified in the respective offer documents and also in violation of the provisions of the RBI Basel III Master Circular 2015**
   The Bank, vide the Write-down Disclosure, wrote-down two of its three outstanding AT1 Bonds.

[2] Yes Bank Reconstruction scheme in exercise of the powers conferred under section 45 of the Banking Regulation Act, 1949. Also see: RBI Press Release: 2019-2020/2022

[3] DOR. PSBD. No. 7117/16.01.137/2019-20

[4] RBI Press Release: 2019-2020/2028

[5] Available at http://egazette.nic.in/WriteReadData/2020/218653.pdf

[6] Yes Bank Basel III Disclosures. Available at: https://www.yesbank.in/footer/regulatory-policies/regulatory-disclosures-section

The two bonds written down by the Bank had an aggregate value of INR 8,415 crores. This included AT1 Bonds worth INR 3,000 crores issued on December 23, 2016 and another of INR 5,415 crores issued on October 18, 2017.[7]

In the Write-down disclosure, the Bank relied on clause 2.15 of Annex 16 of the 'Master Circular - Basel III Capital Regulations' issued by RBI ("**Basel III Circular"**) to write down the AT1 Bonds.[8] The said clause, *inter alia*, states that:

> *"…AT1 instruments will be fully converted/written-down permanently before amalgamation/reconstitution in accordance with these rules."*

Further, RBI provided that the banks *"…should clearly indicate in the offer document, the order of conversion / write-down of the instrument in question vis-à-vis other capital instruments which the bank has already issued or may issue in future, based on the advice of its legal counsels."* [9]

According to the "order of write-down" specified by the Bank in the respective offer documents:

> *"The order of write-off of the Bonds shall be as specified in the order of seniority as per this Information Memorandum."* [10]

In the respective Information Memorandums of the AT1 Bonds, the bank states that the claims of the AT1 Bondholders in the Bonds *"…shall be superior to the claims of investors in equity shares and perpetual non-cumulative preference shares issued by the Bank."*[11] The AT1 Bonds, worth INR 8,415 crore, which were written down by the Bank were senior and higher in order of claim than the common equity and preference shares issued by the Bank.

Accordingly, the clause as regards 'order the write-down' in the respective Information memorandums required equity and preference shares of the Bank to be completely written down before the write-down of the AT1 Bonds.

Furthermore, in the Information Memorandum of the tranche of AT1 Bond issued by the bank on 31st December 2013, the clause as regards 'order of write-down' read:

> a. *In the event of occurrence of Loss Absorption Events at the Objective Pre-specified Trigger point and Point of Non-Viability (PONV), **the Common Equity Capital shall be written down first**. The Common Equity Shareholders shall rank pari-passu amongst themselves for*

[7] Ibid.
[8] Point 2 of the disclosure document.
[9] RBI's Master Circular – Basel III Capital Regulations. Available at: https://rbidocs.rbi.org.in/rdocs/notification/PDFs/58BS09C403D06BC14726AB61783180628D39.PDF
[10] Supra Note 6.

Loss Absorption.

b. *All the Basel-III Compliant Perpetual Debt Instruments (PDIs) (including this Tranche) qualifying as Additional Tier-1 instruments issued by the bank/to be issued in future by the Bank, which have Loss Absorption Clause at the Objective Pre-specified Trigger point and Point of Non-Viability (PONV) as per the terms and conditions of the issue(s) shall rank pari-passu amongst themselves and hence shall be Temporarily written-down (Full/partial) or Permanently Written-Off (Full/partial) in pari-passu upon the occurrence of Loss Absorption Trigger Events at the Objective Pre-specified Trigger point and Point of Non-Viability (PONV).* ***The Write Down of PDI instruments, as mentioned above, shall be done subsequent to the Write-Down of Common Equity Capital.***

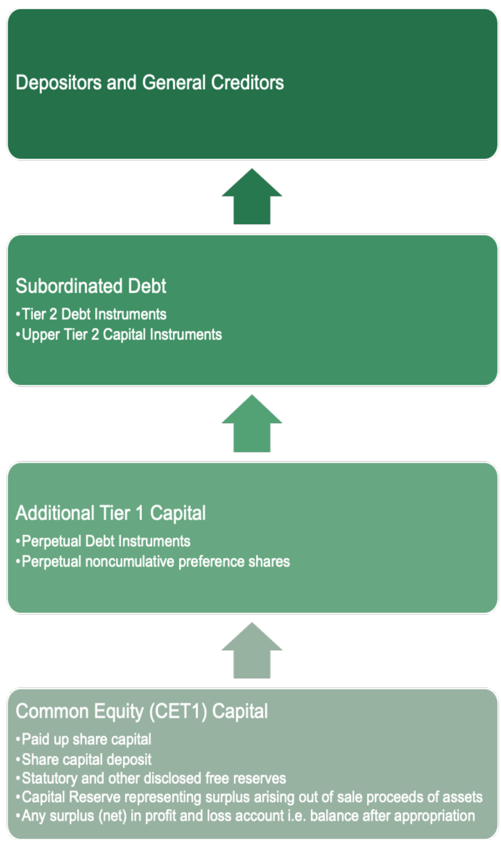

Figure 1 - Order of write-down of AT1 Bonds

It is pertinent to note that the order of Write-down was only expressly mentioned in the AT1 bond issuance made in 2013, which was not written-down. As mentioned above, the AT1 Bond issuance made in 2013 also stated that the order of write-down shall also be followed for the AT1 bonds issued in future. Thereby, implying that that order of write down was applicable to the subsequent tranches of AT1 Bonds issued by Yes Bank and which were eventually written off.

In sum, it can be argued that the write-down of the two AT1 Bonds issued by the Bank was not in accordance with the provisions/order specified by the Bank in the Information Memorandums.

2. **The Bank and RBI did not follow the provisions of the Yes Bank Ltd. Reconstruction Scheme, 2020, as notified by the Government of India and the Banking Regulations Act 1949**

On 5 March 2020, RBI as per Section 36ACA, in consultation with the Union of India **("UOI")**, superseded the Board of Directors of YBL for a period of 30 days owing to serious deterioration in the financial position of the Bank. This was done to quickly restore depositors' confidence in the Bank, which included putting in place a scheme for reconstruction or amalgamation. Shri Prashant Kumar, ex-DMD and CFO of State Bank of India was appointed as the administrator under Section 36ACA (2) of the Banking Regulation Act **("BR Act")**. It evident that as required by Section 36ACA (2) this was also done with consultation of UOI.

It is pertinent to note that on the same date, i.e. 5 March 2020, in exercise of the powers conferred by sub-section (2) of section 45 of the BR Act, UOI vide notification no. S.O. 993(E), after considering an application made by the Reserve Bank of India under sub-section (1) of that section, made an Order of Moratorium in respect of YBL for the period starting from 18:00 hrs on March 5, 2020 up to and inclusive of April 3, 2020. The Order also stayed the commencement or continuance of all actions and proceedings against YBL during the period of moratorium.

Section 45 of the BR Act empowers the RBI to apply to Central Government for suspension of business by a bank and to prepare a scheme of reconstitution to revive the same. In order to effect a restructuring of YBL (which was under a moratorium imposed by the UOI), the RBI, in exercise of the powers conferred on it by S. 45(4) of the BR Act, had prepared the Draft Scheme on 06.03.2020. The Draft Scheme, with regards to AT1 Bonds, provided that:

> *"**6. Rights and liabilities of the Reconstructed bank:-***
> *…All the deposits with and liabilities of the Reconstructed bank, except as provided in the scheme, and the rights, liabilities and obligations of its creditors, will continue in the same manner and with the same terms and conditions, completely unaffected by the Scheme.*
> ***The instruments qualifying as Additional Tier 1 capital, issued by the Yes Bank Ltd. under Basel III framework, shall stand written down permanently, in full, with effect from the Appointed date. This is in conformity with the extant regulations issued by Reserve Bank of India based on the Basel framework.***
> *No accountholder shall be entitled to get any compensation from the Reconstructed bank on account of the changes occurred in the Reconstructed bank by virtue of the Scheme…"*

The Draft Scheme, in accordance with Section 45(7) of the BR Act, was placed before UOI for final approval and to be notified in the official gazette. It is pertinent to note that Section 45(7) of the BR Act provides that:

> "*(7) The* ***scheme shall thereafter be placed before the Central Government for its sanction and the Central Government may sanction the scheme without any modifications or with such modifications as it may consider necessary, and the scheme as sanctioned by the Central Government shall come into force on such date as the Central Government may specify*** *in this behalf:*
>
> *PROVIDED that different dates may be specified for different provisions of the scheme."*

UOI after making modifications to the Draft Scheme, sanctioned the Final Scheme on 13 March 2020 vide Notification No. G.S.R. 174(E). However, the Final Scheme that came into force had been modified to the extent of **specifically excluding the provision pertaining to AT1 Bonds as provided in the Draft Scheme**. The sanctioned Final Scheme provided as follows:

> *"**6. Rights and liabilities of reconstructed bank.—***
>
> *(1) Unless otherwise expressly provided in this Scheme, all contracts, deeds, bonds, agreements, powers of attorney, grants of legal representation and other instruments of whatever nature, subsisting or having effect immediately before the commencement of this Scheme, shall be effective to the extent and in the same manner, as was applicable before such commencement.*
>
> *(2) It shall not be necessary to obtain the consent of any third party or other person who is a party to any of the aforesaid instruments or arrangements to give effect to them.*
>
> *(3) All the deposits with and liabilities of the reconstructed bank, except as provided in this Scheme, and the rights, liabilities and obligations of its creditors, shall continue in the same manner and with the same terms and conditions, completely unaffected by this Scheme.*
>
> ***~~The instruments qualifying as Additional Tier 1 capital, issued by the Yes Bank Ltd. under Basel III framework, shall stand written down permanently, in full, with effect from the Appointed date. This is in conformity with the extant regulations issued by Reserve Bank of India based on the Basel framework.~~***
>
> *(4) No person shall be entitled to get any compensation from the reconstructed bank on account of the changes in the reconstructed bank by virtue of this Scheme.*
>
> *(5) Any cause of action accrued, suit, appeal or other proceeding of whatever nature pending, and decree or recovery certificate obtained by or against the reconstructed bank, shall remain unaffected by this Scheme."*

According to Clause 6(1) of the Reconstruction Scheme:

> *Unless otherwise expressly provided in this Scheme, all contracts, deeds, bonds, agreements, powers of attorney, grants of legal representation and other instruments of whatever nature, subsisting or having effect immediately before the commencement of this Scheme, shall be effective to the extent and in the same manner, as was applicable before such commencement.*

Further, according to Clause 6(3) of the Reconstruction scheme:

> *All the deposits with and liabilities of the reconstructed bank, except as provided in this Scheme, and the rights, liabilities and obligations of its creditors, shall continue in the same manner and with the same terms and conditions, completely unaffected by this scheme.*

However, on 14 March 2020, the very next day of passing of the Reconstruction Scheme by the Ministry of Finance, YBL issued a regulatory disclosure whereby it stated that it had fully written-down the AT1 Bonds of the Bank. The issue was also highlighted by the statutory auditor of the Bank, BSR & Co. LLP.

The omission of the provision for 'write-down of AT1 capital' from the sanctioned Final Scheme, which had gained statutory nature by being notified by UOI, is an integral part of the Final Scheme. Thus, the write-down of the AT1 bonds by YBL is ultra vires and in violation of the Final Scheme notified by the UOI.

Further, as per Section 45(3), YBL could not have "during the period of moratorium make any payment to any depositors or discharge any liabilities or obligations to any other creditors." The moratorium, as per Section 11 of the Final Reconstruction Scheme dated 13 March 2020, came to a cessation "on the third working day at 18:00 hours from the date of commencement of this Scheme", i.e., the moratorium came to a cessation on 18 March 2020. However, it is an undisputed fact that the Administrator of YBL under the directions of RBI and in consultation with UOI, went ahead and wrote down the AT1 Bonds vide YBL's disclosure document dated 14 March 2020 in violation of the section 45(3) of the BR Act.

It is pertinent to note that the Government of India had notified the 'Yes Bank Ltd. Reconstruction Scheme, 2020' on 13 March with the objective of protecting the interest of depositors and providing stability to Yes Bank as well as to the entire financial system. Further, the provisions of the Final Reconstruction Scheme notified by the UOI under Section 45(7) were binding on YBL and the Administrator of YBL appointed by RBI (in consultation of the UOI) under section 45(8) of the BR Act. However, the RBI and YBL have gone ahead and unconditionally written off AT1 bonds in evident violation of Section 6 of the Final Reconstruction Scheme, and the provisions of the BR Act. The contravention of the final notified Scheme under Section 45(7) of the BR Act is even made punishable under Section 46 of the BR Act providing a penalty for the contravention, but no action has been taken against the regulator or the Bank.

The BR Act has also empowered UOI under Section 45(10) of the BR Act to issue any orders so as to remove difficulties in giving effect to the Scheme. However, it is evident that no such power was exercised by UOI in the present case, and if RBI, YBL, or the Administrator of YBL were faced with difficulties in giving effect to the final sanctioned reconstruction scheme, such order under Section 45(10) could have been passed. But UOI, after applying its mind, decided to amend the Draft Scheme to the extent of overtly deleting the clause that gave unfettered right to YBL to unconditionally write off the AT1 Bonds.

3. The issued AT1 Bonds were not considered *pari-passu*

As per the Basel III FY 2019-20 nine-months disclosure dated 31 December 2020, the Bank had INR 8,695 crores worth of outstanding AT1 Bonds. These included the following three AT1 Bonds[17]:

Instrument	Date Issued	Issue Size *INR CRORES*
10.50%, Unsecured, Non-Convertible, Basel III compliant Additional Tier I Subordinated Bonds in the nature of Debentures	31/12/2013	280
9.50%, Unsecured, Non-Convertible, Basel III compliant Additional Tier I Subordinated Bonds in the nature of Debentures	23/12/2016	3,000
9.00%, Unsecured, Non-Convertible, Basel III compliant Additional Tier I Subordinated Bonds in the nature of Debentures	18/10/2017	5,415
TOTAL		**8,695**

On 14 March 2020, the Bank wrote down only the two bonds worth INR 3,000 crores and INR 5,415 crores. The AT1 Bond carrying 10.50% coupon rate, worth INR 280 crore, was still outstanding as per the regulatory filing made by the Bank on 6 May 2020.[18]

According to the offer document of the AT1 Bond issued by the bank on 31 December 2013[19]

> *"...**all** AT1 Bonds issued by the bank / to be issued in future by the Bank shall rank pari-passu amongst themselves and hence shall be Temporarily written-down (Full/partial) in pari-passu."*

[17] Supra Note 6
[18] Q4FY20 Earning's Report. Also see: https://www.bseindia.com/bseplus/AnnualReport/532648/5326480320.pdf
[19] Yes Bank Basel III Disclosures. Available at: https://www.yesbank.in/footer/regulatory-policies/regulatory-disclosures-section

Further, the clause as regards seniority of claim in the respective Information Memorandums of the two tranches of bonds also state that:

> *"The claims of the Bondholders in the Bonds shall rank pari passu without preference amongst themselves."*

The CEO and MD of the Bank, Shri Prashant Kumar, in the earning's call held on 8 May 2020, said that AT1 Bonds worth INR 280 crores were *"not BASEL-III compliant"* and hence could not be written-off. However, the very name of these bonds issued by the Bank has the words "Basel III compliant" imprinted on it. Moreover, these bonds were included by the Bank in its calculations for the purpose of compliance with the Basel III regulations.[20]

Hence, the AT1 Bonds issued by the Bank were not considered pari passu at the time of write-down and were not written down in pari-passu.

Additionally, Annex 1 of the RBI Master Circular 2015 titled "*Criteria for Classification as Common Shares (Paid-up Equity Capital) for Regulatory Purposes – Indian Banks*" clearly provides as follows:

> "9. ***It is the paid-up capital that takes the first and proportionately greatest share of any losses as they occur.*** *Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and pari passu with all the others."*

It is further provided in the footnotes of the above provision that:

> "***In cases where capital instruments have a permanent write-down feature, this criterion is still deemed to be met by common shares***."

It is evident from a plain reading of the above provisions that YBL by writing down the AT1 Bonds without first writing down equity is in direct violation of the provisions mentioned above. It is clear that YBL under the aegis of the RBI Administrator was required to write-down equity to account for the majority of the losses incurred by YBL, but the AT1 Bonds worth INR 8,415 crores were permanently written off instead.

Conclusion

It is evident that the Bank had breached the RBI mandated Common Equity (CETl) ratio and tier 1 capital ratio which stood at 6.3%.and 6.5%. However, as illustrated above, it will not be too far off a logical leap to conclude that the write-off is illegal and arbitrary primarily due to the following reasons:

I. YBL under the aegis of the RBI has written-off the AT1 bonds in violation of the provisions

[20] Available at: https://www.yesbank.in/pdf?name=yesbank_reslutscall_2019_20_q4_pdf.pdf

of the RBI Master Circular 2015 and the procedure of write-down provided in the respective IM/ Offer Documents of AT1 Bonds;

II. Write off is ultra vires and in violation of the Final Scheme notified/Sanctioned by the UOI under Section 45(7) of the BR Act;

III. The write-off of only the AT1 Bonds issued on 23/12/2016 and 18/10/2017 and not the AT1 Bonds issued on 31/12/2013 violates the *pari-passu* nature of the AT1 bonds as clearly specified in the respective IM/Offer documents

Evidently, by acting arbitrarily and in disregard of the legal provisions, RBI has set a wrong precedence and created a security riskier than equity. This has impacted the entire INR 100K crores worth AT1 Bond market, but also especially the bond holders of YBL, who are still fighting their battles against the goliaths of the banking sector across various legal forums in the country, hoping to salvage their investments.

List of Dates:

Particular	Date
RBI'S Guidelines on Implementation of Basel III Capital Regulations in India[21]	May 2, 2012
10.50% Unsecured, Non-Convertible, Basel III compliant Additional Tier I Subordinated Bonds in the nature of Debentures	Dec 31, 2013
RBI Implementation of Basel III Capital Regulations in India – Amendments[22]	Sep 1, 2014
RBI Master Circular – Basel III Capital Regulations[23]	Jul 1, 2015
9.50% Unsecured, Non-Convertible, Basel III compliant Additional Tier I Subordinated Bonds in the nature of Debentures	Dec 23, 2016
9.00% Unsecured, Non-Convertible, Basel III compliant Additional Tier I Subordinated Bonds in the nature of Debentures	Oct 18, 2017
Yes Bank Basel III FY 2019-20 Nine Months Disclosure [24]	Dec 31, 2019
Yes Bank Ltd. placed under Moratorium[25]	Mar 05, 2020
Appointment of Administrator - Yes Bank Ltd.[26]	Mar 05, 2020
Yes Bank Ltd.: RBI announces Scheme of Reconstruction[27]	Mar 06, 2020
Yes Bank Ltd. Reconstruction Scheme, 2020' notified by Government of India[28]	Mar 13, 2020
Independent Auditor's Review Report pursuant to Regulation 33 of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015[29]	Mar 14, 2020
Disclosure under Regulation 51 of SEBI (LODR) Regulations, 2015 regarding write down of AT1[30]	Mar 14, 2020
Reserve Bank appoints additional directors on the board of Yes Bank Ltd.[31]	Mar 20, 2020
Yes Bank Basel III FY 2019-20 Annual Discloser[32]	Mar 31, 2020

[21] https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=7174&Mode=0
[22] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=9202&Mode=0
[23] https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=9859&Mode=0
[24] https://www.yesbank.in/pdf/basel_iii_disclosure_dec_31_2019.pdf
[25] https://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=49476
[26] https://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=49477
[27] https://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=49479
[28] http://egazette.nic.in/WriteReadData/2020/218653.pdf
[29] http://bseindia.com/xml-data/corpfiling/AttachHis/f3d1174d-3d67-4dd3-b138-6a7f3ea2b67f.pdf
[30] https://www1.nseindia.com/corporate/YESBANK_15032020001617_Reg51_Discosure.pdf
[31] https://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=49543
[32] https://www.yesbank.in/pdf/basel_iii_disclosure_mar_31_2020.pdf

Annexure-1

Conversion / Write-down mechanism as per RBI's Master Circular on Basel III Capital Regulations and the Offer Document.