ISAS Insights
No. 605 – 21 March 2020

Lessons from the Yes Bank Saga in India

Vinod Rai

Summary

One more bank in India has gone belly up. The reform package rolled out by the Reserve Bank of India/government has been appreciated. It has been fairly swift and well structured. The action notwithstanding, the entire episode raises issues of failures in good governance, audit, board and regulator supervision and the cosy nexus between the promoter and those agencies mandated to ensure probity and transparency in the dealings of the bank. The time is ripe to introduce a stringent package of reforms that should ensure deep-rooted correctives in bank administration, supervision and audit.

History speaks of so many instances where countries or institutions that converted a crisis into an opportunity to reform have taken the path to prosperity. On the contrary, countries or institutions that kept taking short-term and ad hoc measures, hoping to implement widespread reforms at a later date, never got to doing so and hence spent all their time lurching from one crisis to another.

India has had a significant number of problems in the financial sector. The first were the public sector banks. Then, we had the private sector banks, followed by non-banking financial companies, Infrastructure Leasing & Financial Services (ILFS) and Dewan Housing Finance Corporation Ltd (DHFL). And now we also have Jet Airways. So, it is not the financial sector alone. Should we wait for the crisis to hit other sectors before we decide to take the bull by its horns and undertake large-scale reforms? The maladies are the same in all sectors: poor corporate governance, inadequate Board-level supervision, the nexus between promoters, auditors, politicians, bureaucrats and bankers, lackadaisical regulatory supervision and, above all, poor standards of business transparency and probity. Irrespective of the business or industry, the very same issues come to the fore every time there is a corporate crisis. India was shocked when Satyam[1] happened. It was then shirked away as 'a one-off' incident. Now it seems to be becoming a routine affair. Scams make headlines. Short-term solutions are rolled out. Band-aid treatment is provided and the issue is soon forgotten, probably because another scam has already hit the headlines. The systemic or core issues leading to a scam do not appear to have been targeted and, hence, the recurrence.

The scale and magnitude of the failures that have surfaced are serious and time is opportune to put in motion a well-structured and widely pervading reform package. It will hit the entrenched hard. It may even upset their cosy business networks; but unless the cancer is exorcised now, Indians may have to forget about of seeing their country become an economic superpower and achieve economic prosperity.

[1] In 2015, Byrraju Ramalinga Raju, chairman of one of India's leading computer companies, Satyam, was convicted of manipulating the company's accounts to the tune of ₹14,162 crore (S$2.74 billion).

Kotak Mahindra Bank and Yes Bank were granted banking licenses on the same day in 2004. The former today has a net worth of about ₹3 trillion (S$58 billion) while Yes Bank has collapsed. Why? The answer has been mentioned earlier. The bank lacked professionalism, probity and good corporate governance. The Chief Executive Officer (CEO), Rana Kapoor, considered himself to be infallible. He brooked no challenge to his authority and even appeared to have appointed a pliant Board. The bank did not have a semblance of internal controls.

There is thus a need to professionalise managements, tighten corporate governance and ensure fiercely independent supervisory boards, which can hold the management to account and ensure that decision making is purely on considerations of merit. Corporate governance must comprehensively cover issues of compliance with the role of ombudsman and whistleblowers well defined. Boards must ensure that balance sheets incorporate all environmental, social and governance parameters and that social accounting is factored in. The role of external auditors has to be well defined so that the accuracy and integrity of financial reporting is ensured. Existing corporate governance laws need to be re-looked at to ensure that auditor independence, internal control assessment, corporate governance parameters and enhanced financial disclosures are adequately provided for. Good corporate governance must be defined in newly devised legal frameworks. It must be ensured that these new frameworks are ruthlessly supervised by an objective and impartial regulatory body which is independent of governmental and political interference. This will protect and in the process ensure stakeholder and investor trust. Newly enacted laws must provide for a religious recording of external interference in corporate decision-making. Better risk management and disclosure norms need to be prescribed.

Set up in January 2014, the P J Nayak committee dealing with banking reforms had recommended serious and far-reaching reforms. An important recommendation of the committee was for all banks to have independent, capable and experienced directors at the Board level. As early as 2000, as a standard of corporate governance and as a major step towards codifying corporate governance norms, the Securities and Exchange Board of India (SEBI) enshrined Clause 49 in the Equity Listing Agreement, which stipulates that half the Directors on a listed company's Board must be Independent Directors. The SEBI had also listed the responsibilities of the Audit Committee, which was to have a majority of independent Directors. Independent Directors are primarily meant to oversee the functioning of the Board and ensure that the decisions it makes do not hurt the interests of minority shareholders. The current norms stipulate that two-thirds of the members of the Audit Committee including the Chairman should also be independent. In theory, Yes Bank's Board may have had two-thirds of its Directors 'independent', but whether they were truly independent of the influence of the promoter is the moot point. There has been a tendency among certain institutions, as was seen in the case of the ILFS and now Yes Bank, to have marquee names among its Directors to project an image of its credibility. However, to what extent these Directors were instrumental in exercising supervisory control over the management is debatable. There is also no mechanism to verify the 'fit and proper' criteria of persons appointed as Directors on private banks. (In fact, some of the Directors appointed on public sector banks do not possess credentials that would even remotely justify their appointment). There is a clear nexus between promoters and the Directors appointed on the Boards of banks, which needs to be stopped. Boards need to be manned by professionals in the field of banking, financial technology, risk management, information technology, human resources and the like. These experts should be clearly independent and not have any links with the management or the promoters.

Certain bankers tend to take decisions which may be risky or sub optimal merely for higher interest, processing charges or collaterals. Quite often, one such decision taken may go wrong which then prompts further cover up action to recover the amounts leading to a snowballing effect. The more serious problem is that of collusion when due processes are not followed and often the decision to lend is taken under opaque circumstances. We have been hearing about this situation from the time of Dabhol/Enron and Satyam to Yes Bank and yet remedial steps do not appear to be bearing fruit. Instances of advances made in return for reciprocal benefits provided by the borrower have come to the fore in so many cases and yet the Boards and professional managers have not been able to take steps to guard against such 'considerations'. Accountability in the sector is pursued only when the misdemeanor comes before an investigative agency. The fundamental failing is the issue not being dealt with at the initial stage itself.

It has been recognised that in the Yes Bank case, the Reserve Bank of India (RBI) has introduced a reform package that will not erode shareholder value and minimise pain to depositors and clients. However, questions are being raised as to why the RBI did not heed the early warning signals that were emerging from as early as 2017 when the loan book size of the bank jumped from ₹98,210 crore (S$20.3 billion) in March 2016 to ₹132, 263 crore (S$27.5 billion) in March 2017 and ₹203,534 crore (S$42 billion) in March 2018. The latter two years were following the demonetisation. The rather rapid growth in Yes Bank's loan book raised eyebrows in the market. The credit record of its corporate borrowers created further anxiety. The fact that the loan was at a higher interest rate or that a substantial sum was taken up front as a processing fee did not in any way ring fence the account from default. And that is exactly what happened. How is it that RBI inspections did not enforce more prudential lending or higher provisioning for such risky advances? In 2017, heavy exposure to various lower-rated corporates and assessment of large-scale divergences in reporting non-performing assets (NPA) was noticed. Further, the discovery of weak compliance and wrong asset classification should have brought about immediate leadership change. The regulator need not have waited to withhold the renewal of the promoter CEO's term, let alone the fact that he was granted an extension of about four months beyond his tenure.

As on 31 March 2014, which was roughly 10 years after the bank commenced operations, its loan book size was ₹55,633 crore (S$11.5 billion) and deposits were ₹74,192 crore (S$15.4 billion). However, by March 2019, viz within four and a half years, the loan book had grown to ₹241,499 crore (S$50 billion). Within this period, asset quality continued to worsen and NPAs rose sharply from 0.31 per cent to 7.39 per cent. Alarm bells should have begun to ring rather loud when Yes Bank posted a loss for the first time in March 2019 – that was when the new CEO had joined. Credible market analysts have now started seeking that accountability be enforced on the regulator too. The bank had a heavy exposure to troubled companies such as DHFL, Anil Dhirubhai Ambani Group and ILFS. The RBI decided not to grant extension to its CEO beyond August 2018 when his term ended, but soon permitted him to stay on until January 2019. It required the Chairman of the Audit Committee of the

Board to resign and go public regarding severe governance issues that the RBI/government was compelled to act. This was a good one year after a new CEO had been appointed to replace the earlier promoter CEO.

There is no substitute for effective and stringent supervision. Supervision should not only be thorough and timely, but misdemeanours detected in the course of inspection should be seen to attract very stringent action. This will have a deterrent effect for those planning any insidious attempt to beat the system. In this case, the steady decline in the financial health of Yes Bank was known for over two to three years. There is no excuse for the RBI to have given the management such a long rope. In fact, it would serve the RBI well if it sets up a specialised unit in the nature of a mobile audit/inspection unit, independent of the inspecting team designated to step in on the whiff of suspicion emerging from any institution. It would be worthwhile to experiment with a system wherein, if an early alarm signal kicks in, a totally new team of inspectors from the RBI takes over the inspection so as to ensure that any whiff of a cosy nexus developing is avoided. Such a team would be strangers to the bank management and therefore would not be biased by any pre-existing links.

Auditors, though a much detested clutch of functionaries, are at the core of ensuring good and capable governance. In a banking institution, the role of audit is far more critical because of the fiduciary responsibility cast on the bank, which is the custodian of public deposits. A robust audit function helps in building up trust between the bank and its clients. It is essential that a well-structured internal audit function is initially put in place. More than any other external authority, it provides confidence to the management and Board of Directors. There is then the requirement of selecting external auditors who should be truly independent and rotated every three years. It should be the responsibility of the regulator to ensure that credible and independent auditors are appointed by the bank's annual general meetings. There have been many cases in which, despite the auditor having given an 'all clear' report to the Board, the institution has gone belly up soon after. Such instances need to be examined with alacrity with lapses on the part of the auditor being fixed and strict disciplinary action being taken by the RBI and the Institute of Chartered Accountants of India.

No argument can acquit an auditor who is meant to be hard-nosed in sniffing out acts of omission and commission. They should be able to see through attempts of window dressing by the management. In case they are not able to see through such demeanours, they really do not deserve to be engaged as auditors. This is the responsibility of the RBI, and under these occasions it would not only be failing in its duty to isolate such instances, but would also have its own credibility brought under glare. A minimum of three years suspension of the partners/team which handled the audit must be ensured. There have been far too many cases of auditor neglect, incompetence and/or complicity for this aspect to be permitted to pass without prompt, stringent action. Finally, it is the responsibility of the RBI's inspection team to ferret out instances of misdemeanour by the management. The RBI, which prides itself on the competence and independence of its officers, must introspect and ascertain what action has been taken by it on its own as an institution in all recent instances of failures. Even if it has introspected, there should be no hesitation in its making public the action taken, as that would buttress the fact that it will not spare its own in similar circumstances. It would help to infuse a huge amount of confidence towards the institution in the public mind.

In any economy, banks play a very critical role. For the economy to be robust, its banks and financial institutions have to be robust as well. They are the custodians of public savings. Any lack of confidence of a depositor in a bank is bound to erode the trust that the depositor would have in placing his savings in the bank. This can have very deleterious effects, as the common man does not understand the complexities of banking. He merely wants his money to be safe in the bank – the bank and the RBI must, consequently, provide that confidence to him. With banks now showing signs of weak financial health, urgent steps are called for to prepare a roadmap for sustainable reforms. The earlier these reforms are implemented, the faster the economy will be able to regenerate.

. . . . .

Mr Vinod Rai is a Distinguished Visiting Research Fellow at the Institute of South Asian Studies (ISAS), an autonomous research institute at the National University of Singapore (NUS). He is a former Comptroller and Auditor General of India. He can be contacted at isasvr@nus.edu.sg. The author bears full responsibility for the facts cited and opinions expressed in this paper.

Institute of South Asian Studies | National University of Singapore | 29 Heng Mui Keng Terrace, #08-06 (Block B), Singapore 119620
Tel: (65) 6516 4239 | Fax: (65) 6776 7505 | www.isas.nus.edu.sg | http://southasiandiaspora.org