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R&I India Flash Report

YES BANK BAIL-OUT: CRITICAL INVESTOR ISSUES

13 March 2020

On 5 March 2020, the Reserve Bank of India ("**RBI**") imposed a moratorium on Yes Bank following unsuccessful attempts to raise additional capital to cover provisions for non-performing assets and a deterioration of its financial position. This was against the backdrop of the downgrading of Yes Bank's credit rating and concerns over its corporate governance. The RBI has taken over Yes Bank's board and imposed limits on withdrawals to protect the interests of depositors until 3 April 2020. This was followed by a draft scheme of reconstruction published by the RBI on 6 March 2020 for rehabilitation of Yes Bank ("**RBI Scheme**").

The RBI Scheme is likely to be amended and a revised scheme is expected to be published imminently. At the time of publication of this client alert, it has been reported that Indian cabinet has approved a revised version of the RBI Scheme. These revisions may affect the percentage of equity to be held by the government entities participating, the cash that they are investing, the participation by potential co-investors and the treatment of Additional Tier I Capital ("**AT-1**") (or its conversion into equity). However, the key issues are likely to remain similar and we have summarised these matters in this client alert.

A chronology of the events that led to the issuance of the RBI Scheme is set out in **Appendix 1** and detailed analysis of the potential issues arising out of the proposed reconstruction are discussed in **Appendix 2**.

Key Issues

- **Current RBI Scheme**: Yes Bank is under a moratorium imposed by the RBI and will be subject to a scheme under the Banking Regulation Act 1949 ("**BR Act**") rather than under the Insolvency and Bankruptcy Code, 2016 ("**IBC**") or the Companies Act 2013 ("**CA 2013**"). The current RBI Scheme contemplates investment in the equity of Yes Bank by the State Bank of India ("**SBI**") of 49% of the total share capital at a price not less than INR 10 per share (inclusive of a premium of INR 8 per share) with a 3 year lock in which will see SBI maintain a shareholding of at least 26%. The board of Yes Bank is also proposed to be reconstituted. The RBI Scheme further contemplates a full write down of the AT-1 instruments issued by Yes Bank. This write down is the subject of litigation from certain AT-1 bondholders. However, subsequent media reports suggest that other investors, including various Indian financial groups may participate in the RBI Scheme and that AT-1 bondholders will receive the benefit of a conversion of part of their bonds into equity.

> **Comment**: Regardless of whether or not the RBI Scheme is amended, structurally, there are three issues of note. First, in order for the RBI Scheme (or any variation of it) to succeed, it will need to be aligned to the capital required. The key issue is how much capital will be needed? Second, how will any future capital requirements be satisfied? Will investors be willing to invest further capital, if needed? Experience in other markets shows that the immediate capitalisation may be followed by further equity issuances later. Third, the RBI Scheme envisages a share premium of INR 8. This implies there is equity value left in the company, which would seem incongruous if the AT-1 bonds are being written down. Appropriate pricing of the transaction reflecting the economic position is critical in order for the RBI Scheme to succeed in its objectives. The RBI is expected to publish the final RBI Scheme imminently so clarity on this will emerge soon.

- **Write down of AT-1 bonds**: The current RBI Scheme contemplates a full write down of the AT-1 instruments issued by Yes Bank. The AT-1 bondholders have challenged the write down before the Bombay High Court on the grounds that such scheme gives preference to shareholders and is against global best practices. Media reports suggest that the bondholders have postponed the matter as the RBI is considering conversion of a portion of the bonds into equity of Yes Bank, so it may be that this aspect of the RBI Scheme changes.

> **Comment**: The RBI has the power to write down all AT-1 instruments pursuant to the Basel III Capital Regulations and the BR Act. However, certain bondholders are challenging this on the grounds of a lack of fairness of the scheme, given that the RBI Scheme proposes investment in Yes Bank's equity at a premium, while the bonds (which rank in priority to common equity) are being written off. Media reports suggest that the RBI has taken note of the bondholders concerns and may offer them the right to convert a part of their bonds into equity in the revised RBI Scheme. The more difficult issue is around the treatment of Tier-2 bonds. Depending on the scale of capital required, will these also need to be written down? From an investor perspective, this is a key issue that will need to be addressed or diligence will need to provide evidence that this will not be required. A failure to address this issue clearly at the outset could potentially lead to further capital calls later or an erosion of the value being provided by investors under the RBI Scheme (or any revised version of it).

- **Tax**: Any acquisition of equity at a low valuation will need to be structured in a manner that does not lead to adverse tax consequences. Acquisition of shares at less than "*fair market value*" in any bail-out may be treated as taxable income in the hands of investors.

> **Comment**: This is a critical issue for investors, who will not want to be penalised for appropriate pricing and investors should seek tax advice on this aspect.

- **Investor eligibility**: It is likely that any meaningful participation by investors will need RBI approval. This is because any acquisition of shares or voting rights in excess of 5% of Yes Bank, requires the prior approval of the RBI. The RBI has placed limits on ownership based on categories of investors (where no acquirer can exercise voting rights in the bank in excess of 10%), but the RBI has the power to relax such requirements if such acquisition is in the public interest. Further, any bidder proposing to acquire Yes Bank will need to fulfil RBI's '*fit and proper*' criteria and be able to demonstrate its financial and operational capability to run a banking business.

  > **Comment**: This is an RBI requirement, so the RBI may be prepared to be flexible within boundaries to address the capital needs.

- **Listed company issues**: Unless the Securities and Exchange Board of India ("**SEBI**") is willing to grant exemptions in light of the exceptional circumstances, various securities regulations will apply. For instance, the scheme is likely to need an exemption from SEBI if the takeover requirements in India are not to apply. Schemes under CA 2013 or resolution plans under the IBC are exempt from these requirements, but a scheme under the BR Act is not specifically carved out. Similarly, SEBI has various pricing and other requirements for the preferential allotment of shares. Will SEBI be willing to grant a specific exemption here? Investors will also need to consider the possibility that they might be treated as "*promoters*" of Yes Bank depending on the size of their investment. Also, investors will need to consider insider trading issues around access to 'unpublished price sensitive information' at the time of conducting diligence. Finally, investors should not expect to retain a set of customary private company style investor protections as long as Yes Bank remains listed. SEBI has allowed limited investor rights (such as board nomination rights) in the past, but expectations should be managed as far as what may be possible and as to the influence they will have on management of Yes Bank going forward.

  > **Comment**: These are practical issues that will need to be worked through. Much depends on whether SEBI and the RBI work together in a concerted fashion to ensure that the scheme is complemented with supporting flexibility from SEBI.

- **Money laundering risk**: It is alleged that Yes Bank's ex-promoter, Rana Kapoor received kick-backs for loan recovery forbearance by Yes Bank from Dewan Housing Finance Limited ("**DHFL**") and he is under investigation by the enforcement directorate ("**ED**"). Under Indian law, any person who directly or indirectly is involved in the 'proceeds of crime' and claims such property to be 'untainted' is guilty of the offence of money laundering and the Government has the power to attach the assets (or value equivalent) involved in the offence of money laundering.

> **Comment**: Since the bail-out of Yes Bank is outside the scope of the IBC (where bidders are immune from offences committed by the ex-promoters), there is some risk that the allegations of fraud involving Rana Kapoor could lead to attachment of Yes Bank's assets. However, such attachment will need to follow the process set out under law in this regard.

Where Next?

- At the time of publication of this client alert, it has been reported that the Indian cabinet has approved certain revisions to the RBI Scheme, so the revised RBI Scheme is expected to be published shortly. Media reports suggest certain Indian financial groups and other Indian investors are likely to co-invest with SBI to fund the capital shortfall in Yes Bank. It remains to be seen as to what shape the RBI's ultimate scheme takes, but in similar banking crises in Europe, ultimately, the state has needed to bail-out financial institutions. Therefore, even if private investors do participate, from an economic perspective, they may view their investment as having an implicit "put" to the Indian government (not in the sense of formal legal rights, but implied comfort as to the ultimate recourse in relation to further downside).

- The other issue is that it is likely that any immediate rescue plan will only be the first step. Once re-capitalised, the management of Yes Bank may need to consider strategic decisions such as whether to separate out good and bad asset pools, whether to sell better parts of the business and other measures. There is also the question of how to deal with any further capital which may be needed. Will new investors be willing to fund a future rights issue for instance, if further capital needs arise? These are all questions that will need to be considered.

- Much of the restructuring will be simpler if Yes Bank were to de-list as it would allow the resolution of Yes Bank's situation to be undertaken in private and without the ongoing disclosure and other obligations of a listed company. SEBI may not be favourably disposed to this because of public / retail shareholders who may then hold illiquid shares and so it remains to be seen whether the ultimate RBI Scheme features a de-listing, but it is an issue that will need to be structurally considered.

Takeaways for international investors

The success of the RBI Scheme (or any variation to it) will hinge on clearly and verifiably establishing the capital needed in a limited timeframe and addressing the key commercial issue around pricing. The question of "*who bears the pain*" and the speedy implementation of the RBI Scheme will require flexibility from the various regulatory authorities in India. Even if international investors are unable to participate in the current recapitalisation of Yes Bank (or if the terms proposed do not provide them with sufficient comfort), it seems likely that this will be a first step and that the restructuring will be a much longer term endeavour. Therefore, it is possible that there may be further developments and opportunities to invest in the aftermath of the initial capitalisation.

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APPENDIX 1 | CHRONOLOGY OF EVENTS

September 2018	RBI refuses to give CEO, Rana Kapoor, an extension to his term. Rana Kapoor asked to step down by end of January 2019.
November 2018	Yes Bank's foreign currency issuer rating downgraded by Moody's and outlook changed to 'negative' from 'stable' citing concerns over corporate governance.
January 2019	Yes Bank hires the head of Deutsche Bank India, Ravneet Gill as new CEO.
April 2019	Yes Bank faces liquidity crunch and issued public statement stating it will consider raising funds by issuing shares and debt securities.
July 2019	Yes Bank reports 91% drop in first quarter profits, gross NPA ratio reported at 5.01%.
September 2019	CEO Gill announces that Yes Bank close to securing a deal to sell minority stake to a global technology company.
October 2019	CEO Gill announces that Yes Bank in talks with investors to raise additional capital and receives binding investment offer of USD 1.2 billion from global investor.
November 2019	Yes Bank reports a consecutive loss in the second quarter, gross NPA ratio reported at 7.39%.
February 2020	Yes Bank issues report stating that it will delay disclosing its October – December 2019 earnings by a month and that it has received non-binding EOI from certain international investors.
5 March 2020	RBI places Yes Bank under moratorium, and takes over the board of Yes Bank for a period of 30 days and imposes limits on withdrawals to protect the interests of depositors.
6 March 2020	RBI announces the draft RBI Scheme. Comments invited on the draft scheme by 9 March 2020.
8 March 2020	Rana Kapoor is arrested and kept in the custody of the ED on the grounds of alleged money laundering.

9 March 2020	AT-1 bondholders file a writ petition before the Bombay High Court, challenging the write down of the bonds under the RBI Scheme.
11 March 2020	Yes Bank's AT1 bond holders postpone matter before High Court after the RBI showed willingness to negotiate with them on conversion.

APPENDIX 2 | ANALYSIS OF POTENTIAL ISSUES

ISSUE 1: COMMERCIAL ISSUES	
Sizing of the shortfall funding	**Comment**
Identifying the size of the shortfall funding is key to a restructuring which is viable for an incoming investor.	***Size of the capital needs will drive deal structuring*** If SBI is only willing to capitalise a maximum of 49% of Yes Bank, then the size of the capital requirement will drive the number of investors who need to participate, the question of whether the Tier-2 bondholders will suffer any write downs and will also drive the question of future funding, if needed. Therefore, this is the most critical issue.
Pricing of the issuance	
Viability of issuance of equity at a premium From a commercial perspective, can a premium be justified unless there is equity value left and if AT-1 bondholders are either facing a write off or conversion of their bonds into shares? ***Tax considerations*** Acquisition of shares (even on a primary basis) at less than fair market value may result in tax in the hands of investors. There will also be capital gain upon an ultimate exit, although that would apply in any investment.	***Cost of investment*** International investors will want to ensure that the pricing is appropriate and that they are not paying a premium if there is little or no value in the company, so the pricing in the RBI Scheme or any variants to it are critical. Investors will need to seek tax advice in relation to any potential tax exposure on this account.

ISSUE 2: TREATMENT OF ADDITIONAL TIER 1 AND TIER 2 CAPITAL INSTRUMENTS	
Write down of AT- 1 and Tier 2 Capital	**Comment**
Challenge by AT-1 bondholders The AT-1 bondholders have challenged the RBI Scheme before the Bombay High Court which proposed a full write down of the AT-1 bonds on the grounds that such scheme gives preference to shareholders and is against global best practices. Media reports suggest that the bondholders have postponed the matter since they are in talks with the RBI to convert a portion of the bonds into equity of Yes Bank.	***Ability of RBI to write down AT-1 bonds*** The RBI has the power to write down all AT-1 instruments pursuant to the powers vested in it under the Basel III Capital Regulations and the BR Act (the later confers broad powers upon the RBI in relation to schemes). The terms of the publicly available offer document prepared by Yes Bank in 2017 for issuance of AT-1 bonds also recognises the possibility of a write down of AT-1 instruments.[1] ***Ability of RBI to write down Tier-2 bonds*** Although the RBI Scheme does not contemplate a write down of the Tier – 2 capital, both the Basel III Capital Regulations as well as the BR Act allow the RBI to do so. ***Is write down of the AT-1 bonds by RBI arbitrary?*** Whilst there is regulatory basis for writing down of the AT-1 bonds, the bondholders have raised questions on the fairness of the scheme. Media reports suggest that the RBI is amenable to a debt to equity conversion and is in talks with the AT-1 bondholders, so the revisions to the RBI Scheme may take this into account. Therefore, this approach this may resolve the fairness issue without the litigation needing to play out (although some bondholders are still contesting the conversion).
Applicability of CA 2013	
Does the CA 2013 which deals with a court approved scheme of arrangement between a company and its creditors / members apply to the RBI Scheme?	***Overriding provisions in the BR Act*** Although Yes Bank is governed by the provisions of the CA 2013 (which contains provisions for implementation of a court approved scheme of arrangement), there is specific language in the BR Act which states

[1] We assume other AT-1 bond issuances by Yes Bank have similar provisions.

ISSUE 2: TREATMENT OF ADDITIONAL TIER 1 AND TIER 2 CAPITAL INSTRUMENTS	
	that the RBI's ability to frame a policy for reconstruction of a bank shall override anything to the contrary contained in any other law (which will include the CA 2013) or any agreement, award or other instrument.

ISSUE 3: LISTED COMPANY ISSUES	
Acquisition of control of Yes Bank	**Comment**
Will acquisition of equity shares of Yes Bank trigger a takeover offer requirement?	***Exemption from the mandatory offer requirements*** Indian takeover regulations prescribe a mandatory offer (of at least 26% of the total share capital) if any acquirer (along with its concert parties) acquires more than 25% of the share capital or voting rights of a company or 'control' of the listed target, unless any of the exemptions apply. The existing exemptions for resolution plans under the IBC or court approved schemes under the CA 2013 will not apply. However, SEBI has the power to grant bespoke exemptions from making a mandatory open offer if such exemption is sought in the public interest.
Categorisation as 'promoter'	
An incoming investor may be classified as 'promoter' under Indian takeover regulations.	***Who is a 'promoter'?*** The term "promoter" is defined with reference to the level of control over the affairs of the listed company (either by virtue of shareholding, board nomination rights or other contractual rights which confer positive control) and by virtue of being named as a promoter in draft offer document or in the annual return filed by the company. ***Consequences of being a 'promoter'*** The main implications here are in relation to any IPO exit and also in general SEBI treats promoters as being responsible for the running

ISSUE 3: LISTED COMPANY ISSUES	
	of the company and views any breaches by promoters more seriously.
Position of co-investors	
Will the co-investors be treated as 'person acting in concert'?	***Who is considered as 'person acting in concert'?*** The Indian takeover regulations defines persons acting in concert to mean persons who, with a common objective or purpose of acquisition of shares or voting rights in, or exercising control over a target company, pursuant to an agreement or understanding, formal or informal, directly or indirectly co-operate for acquisition of shares or voting rights in, or exercise of control over the target company. Investors participating together with SBI in the RBI Scheme will therefore need to be mindful of this issue, both in relation to the initial investment and also going forward if the company continues to remain listed.
Insider trading issues	
Although material information will need to be disclosed to the market, diligence may expose investors to 'unpublished price sensitive information' ("**UPSI**").	***Issue and potential approaches*** Both the communication of this information and also investments in possession of UPSI (unless cleansed through disclosure) will present issues. Investors will therefore need to use the customary techniques to deal with these issues.
Preferential allotment issues	
To what extent will the SEBI regulations on the preferential allotment of shares need to be satisfied?	***Exemption required*** The applicable SEBI regulations impose a number of requirements in relation to the preferential allotment of shares of a listed company, including pricing (where the floor price is higher of the average of weekly volume weighted average price of the shares calculated for preceding 26 weeks and 2 weeks from the relevant date). Those will need to be exempted in a transaction of this nature (assuming that the pricing does not fall within this range).

ISSUE 3: LISTED COMPANY ISSUES	
	Shareholders' approval Any issue of shares on a preferential basis normally requires the prior approval of 75% of the shareholders of the company both under the CA 2013 as well as SEBI regulations for listed companies (there are exemptions in case of the latter in some cases, but those do not apply in the present case). However, it is possible that these requirements may not apply in any ultimate RBI Scheme. This is because any equity issuance will be pursuant to the RBI Scheme and the provisions of the BR Act will override CA 2013 (if an approach similar to that in the IBC is adopted). SEBI will need to show flexibility to provide a derogation from its rules as the existing exemption for CA 2013 schemes will not apply and the exemption for RBI debt to equity conversion schemes will not apply (other than potentially in a limited manner to any conversion of AT-1 instruments).

ISSUE 4: CONSIDERATIONS FOR NEW BIDDERS	
Eligibility of new bidders	**Comment**
Yes Bank is a listed banking company regulated by the RBI and a bidder proposing to acquire control over a bank is required to meet the requisite eligibility criteria.	***RBI eligibility requirements*** Acquisition of shares or voting rights in excess of 5% of the paid up share capital of Yes Bank requires the prior approval of the RBI.[2] In addition, the RBI imposes ownership limits for various categories of investors (deviations are possible if the RBI considers these to be in public interest), and in the case of strategic investment for rehabilitation, there is a lock in for 5 years, if the RBI allows acquisition of more than 10% of the paid up capital. Also, irrespective of the shareholding permitted by

[2] The requirement for an RBI approval is triggered if a person (along with his relatives, associated enterprises and persons acting in concert with it) makes an agreement for acquisition which will or is likely to take the aggregate holding of such person together with shares / voting rights/ compulsorily convertible debentures/ bonds held by him to 5% or more of the paid up share capital of the bank or entitles him to exercise 5% or more of the total voting rights of the bank.

<table>
<tr><th colspan="2">ISSUE 4: CONSIDERATIONS FOR NEW BIDDERS</th></tr>
<tr><td></td><td>the RBI, no acquirer is permitted to exercise more than 10%[3] of the total voting rights in the company, which can be increased to 26% by the RBI in a phased manner.

Further, a potential bidder will need to comply with the 'fit and proper' criteria set out by the RBI.

Exchange control norms

In addition to the criteria set out by the RBI, Indian exchange control norms also set out investment conditions for investments into a private sector bank (including Yes Bank):
▪ Investment cap: Foreign investment in private sector banks is limited to 74%. At least 26% of the paid-up capital needs to be held by residents (except in regard to a wholly-owned subsidiary of a foreign bank).
▪ Transfer of shares: Transfer of shares from residents to non-residents requires approval of the RBI, as applicable.</td></tr>
<tr><td colspan="2">Impact of on-going money laundering investigations</td></tr>
<tr><td>Will the on-going money laundering investigations against Yes Bank's ex-promoter Rana Kapoor have an impact on an incoming investor on account of attachment of Yes Bank's assets?</td><td>Risk

The ED initiated investigations against Rana Kapoor alleging that Rana Kapoor and his family received kick-backs (in the form of loans provided by DHFL to a company controlled by Rana Kapoor) in lieu of non-initiation of loan recovery by Yes Bank from DHFL which amounts to 'money laundering'.

The concern in this case is whether the allegations of fraud involving Rana Kapoor could lead to attachment of Yes Bank's assets (potentially the loan portfolio held by the bank) under Indian law. This is possible, although the full attachment procedure will involve due process.</td></tr>
</table>

[3] There is a discrepancy in the voting limit thresholds. While the RBI Act, 1934 and Indian exchange regulations limit the voting rights to 10%, the RBI circular dated 12 May 2016 makes a reference to a 15% cap.