Reform of the bankruptcy framework in India

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What is a bankruptcy framework

- A bankruptcy framework lays down rules for what will happen in the case of a business failure.
- The process is, most often, triggered when an entity defaults on its dues. This is known as insolvency.
- Bankruptcy is the formal determination of insolvency with resulting legal steps to deal with it.
- An optimal framework creates a degree of certainty for both the creditors and the debtors on the outcome of business failure.

Why do we need a bankruptcy framework?

- Incomplete and mutually inconsistent contracts.
- Information asymmetry between firms and its lenders.
- Secured versus unsecured credit.
- Enabling risk-taking and enterprise.
- Preserving the going concern value of an enterprise.
- Reducing strategic behaviour.

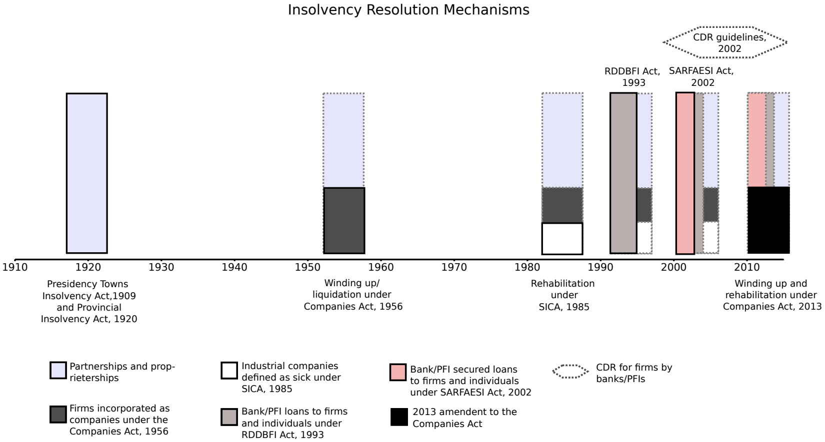
The goals of a bankruptcy framework

- Four principal goals:
  - To enhance the value of the failing debtor.
  - To distribute this value efficiently and optimally.
  - To internalise the costs of the business failure to the parties dealing with the debtor.
  - To create optimal incentives, for both debtors and creditors, ex-ante and ex-post.

Design of an optimal bankruptcy process

- Much debate on what is an optimal process. The choices:
  - Liquidation vs. re-organisation focused
  - Creditor friendly vs. debtor friendly
  - Court driven vs. rule driven
- Actual bankruptcy laws vary widely across countries depending on:
  - Underlying economic and institutional conditions.
  - Path-dependence of economic and institutional development.
  - Political economy factors.
- The design of the framework has an impact on behaviour of creditors and debtors in pre and post bankruptcy states.

The Indian framework



India's performance vis-a-vis other countries

	India	U.S.A.	U.K.	Australia	Singapore
Getting Credit (Rank)	28	3	1	3	3
• Index of legal rights strength (1...10)	8	9	10	10	10
• Private bureau coverage (%)	19.8	100	100	100	60.3
Enforcing Contracts (Rank)	186	11	56	14	12
• Time (Days)	1420	370	437	395	150
• Procedures (No.)	46	32	28	28	21
Resolving Insolvency (Rank)	121	17	7	8	4
• Time (Years)	4.3	1.5	1	1	0.8
• Recovery rate (cents per $)	25.6	81.5	88.6	81.3	89.4
Domestic Credit by financial sector (% of GDP)	77.1	246.1	195.6	158.8	112.6

Source: World Bank Doing Business Report, 2014, World Bank World Development Indicators, 2014

Where we are in India today

- Banks are focused on secured credit. Yet there is a crisis of NPAs on their balance sheets.
- There corporate bond market has not taken off.
- Most firms are unable to access credit.
- The laws and institutions for dealing with failing firms are complicated and inefficient.
- As result promoters are forever.

Reforming bankruptcy law

- The international experience: considerable interest in reform of bankruptcy law in the last 20 years.
- A variety of triggers:
  - The east Asian Crisis and subsequent reforms
  - The fall of socialism in East Europe,
  - The desire to promote entrepreneurship – UK (2002), Brazil (2004), Korea (2011, 2013)
  - Prevention of abuse of bankruptcy law – USA (2005)
- In India, we have tried piecemeal reforms.
  - SICA, 1985
  - RDDBFI, 1993
  - SARFAESI, 2002
  - CDR guidelines
- The IFC already provides for a Resolution Corporation for financial firms.
- Is it time to address this problem comprehensively for non-financial firms?

Considerations for reform of bankruptcy in India

- Re-writing the law – creating a comprehensive code for all enterprises and all creditors.
- Reform of the institutional setting – dealing with court capacity and judicial delays.
- Strengthening ancillary institutions – credit bureaus, collateral registry, insolvency professionals.
- Incentive structures of state owned financial institutions.
- Interaction of bankruptcy laws with other laws governing industries, labour, transfer of property.
- Interaction of corporate insolvency with individual insolvency.