The Indian bankruptcy reforms: How we got here and where we go next

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This talk

- Economic principles driving bankruptcy reforms
- Design principles of the Insolvency and Bankruptcy Code, 2016 (IBC)
- The law that was born in 2016
- Three years later . . .
- Implications for CAG

Some facts

Growth $\leftarrow$ credit

- Economic growth needs capital, where capital = equity and debt.
- In the last two decades, India has grown on equity and current liabilities (of the steadiest source is **trade credit**):

	(% of Total)		
Component	1995-96	2005-06	2015-16
Capital & reserves	**36.3**	**33.7**	**36.2**
Paid-up equity	13.2	9.6	7.3
Retained earning	3.3	3.6	0.5
Other reserves	19.8	20.5	28.4
Borrowing	**38.8**	**32.0**	**33.0**
Banks & FIs	17.5	16.4	16.8
Bonds	6.6	2.1	1.4
Foreign	4.9	3.8	4.6
Inter-corporate	1.8	2.5	2.4
Current liabilities	**23.4**	**27.7**	**31.0**
Number of firms	5,109	14,284	12,457
Total finance (Rs. trillion)	7.4	23.6	122.8

Source: CMIE Prowess

Why we started on the reforms?

- India was unusual relative to several countries in her use of equity to grow.
- But similar to other emerging economies in her use of debt:
  - Misplaced emphasis on secured credit
  - Value destruction when an enterprise "failed"
  - Poor corporate bond market development
  - Poor credit for individuals (and small enterprises that did not have security for credit)
- Several committee reports identified lack of debt contract enforcement in stress as a significant cause for the poor credit ecosystem.

A metric often used: Low insolvency and bankruptcy scores for India in the *Ease of doing business ranking* published by the World Bank. More than 5-7 years to recover after bankruptcy, recovery rate estimated at 20%, capital and labour interminably stuck.

Credit ← insolvency and bankruptcy certainty

- In good times, little difference between equity and debt.

  Equity is expensive – ownership; Debt is cheaper – fixed returns.

  Debt requires monitoring; Equity does not.

- In bad times / stress, equity loses power, debt has to choose whether to:
  - Put in more capital to keep a viable project going?

    • *How much more capital?* • *How much more time to fresh payment?* • *How much of the current debt to sell or keep?*

  - Or declare bankruptcy, close the project down and recover what is fairly due.

    • *What is "fairly due"?* • *How much to whom?* • *What are the assets that are available for recovery to all debt holders?* • *Restricted to some debt-holders?* • *How much value can be recovered by identifying fraudulent transactions?* • *What is the cost and benefit of alternative choices in selling assets?* • *Who gets to choose?*

Matters of *process*. Answers? The bankruptcy laws of the country.

Economic principles

Pause for definitions

Insolvency: the instance of failure to repay.
Two possible causes –

1. Liquidity crisis: a mismatch of cashflows in and out of the enterprise.
2. **Bankruptcy**: the business model is unviable.

Three pillars of insolvency and bankruptcy laws

1. Secured creditor's rights

   What is deemed default? How is this established? Which security can be taken out of the enterprise? What processes are followed for this?

   SARFAESI (2003)- first law for secured creditor rights.

2. Collective insolvency resolution

   What is deemed default? What is the insolvency resolution process to decide liquidity or bankruptcy? What happens to rights of all other stakeholders in the enterprise during this process? Who are the stake holders who decide the resolution of insolvency? What are the rights of those who do not get to decide?

   IBC (2016) - first law for collective insolvency resolution.

3. Bankruptcy resolution (often called liquidation)

   What are the assets available to recover creditor's dues? What is the waterfall of repayments? What happens to the secured creditor's rights and collateral in bankruptcy?

   Companies Act (1956)

Why didn't this work?

Some hypotheses:

- These pieces fell into place at different times in India.

  Large time intervals in between.
- Both debtors and creditors tried to game the system differently, both using the courts. This weakened the judicial processes of contract enforcement.
- Endemic information asymmetry between the enterprise and financial stakeholders.

  Poor accounting standards and practices. Poor enforcement against lack of standards.
- Failure was considered 'bad'.

  In a low capital environment, owners / promoters had the stronger incentives to keep control of the enterprise (and the capital) even at the cost of keeping the enterprise in an inefficient / "zombie" state.

Design focus of the new law

- Enterprise failure to be treated as "normal".
- "Speedy resolution" so that capital and labour can move back into productive work quickly.
- Any creditor should be able to trigger – equal access to provide information about enterprise stress.
- The decision of insolvency resolution should be an "economic decision" and not a judicial one.
- Respect limited liability in failure.

IBC, 2016

Key features

- Single law across all enterprise, small or large, limited liability or partnership.
- Any outstanding above Rs.100,000 can be used to trigger insolvency resolution.
- If accepted, enterprise moves into Stage I: insolvency resolution process (IRP)

  Moratorium on secured creditors during resolution to preserve enterprise value.
  A professional in charge of the firm; owners and promoters lose control.
  Financial creditors as a committee to meet and decide on whether enterprise resolution is possible.

  A decision in not more than 270 days.
- An enterprise deemed "unresolvable" goes to Stage II: Bankruptcy

  Liquidation triggered automatically.
  Normal judicial and stakeholder control during liquidation.
  Clearly defined waterfall – with State dues after secured creditors, workmen, and with unsecured creditors.

Three years later

Progress report on implementation

- From Bill to Law in 9 months – September 2015 to May 2016
- Operationalised in 7.5 months – First cases from January 2017 onwards
- Broad structure retained – two phases of resolution; limited time frame to resolution; professionals managing the insolvent; resolution a business decision;

  But missing details of the processes. Left to rules and regulation.

  Unlike bankruptcy laws world-wide, which have detailed processes.
- First big cases – RBI 12 cases from April 2017 onwards.
- First amendment – January 2018.

Performance assessment: Inputs-Outputs-Outcomes

- Policy initiatives are best jugded in terms of the “inputs”, “outputs” and “outcomes”.
- Useful reading: “The state of the art” of the bankruptcy reforms at the `LEAP blog`.

  `https://blog.theleapjournal.org/2018/12/the-indian-bankruptcy-reform-state-of.html`
- **Key observations:**

Inputs: the reforms process has fared decently well.
Missing: policy certainty.

Outputs: the reforms process has not fared too well.
Missing: average time to resolution, recovery rate under the IBC?

Outcomes: the reforms process appears to be work in progress.

- Some things are positive (increased interest in various market participants in purchasing and managing stressed asset;)
- Some are not (slow capacity development on the largest financial creditors such as the PSE banks, increased dependence on judicial outcomes)

Implications for CAG

IBC and the CAG: some obvious implications

Auditor of the government $\rightarrow$ audit of public sector enterprises.

- IBC permits that any creditor is empowered to put a firm into insolvency review.
- The IBC framework allows a review of the past two years of accounts for fraudulent transfer and malpractices when the firm is under IRP.

$\rightarrow$ Will CAG be the auditor of all PSEs that go under IBC?

Some explicit caveats:

1. IBC applies only to non-financial entities.

   Financial entity resolution is separately handled in the Financial Resolution and Deposit Insurance Bill, the FRDI Bill.

2. Government has discretionary power to keep firms out of IBC.

IBC and CAG: implications

- An audit roles on:
  - PSEs that may be insolvent and go under IBC
  - PSEs that refer firms to IBC
  - PSEs on the creditor's committee of firms in IBC. (Banks)
- Others can include?
  - Tax department claims in IRP.
    A claim written off, should suitably be written off from the books of the government also.
  - Other government claims.
    Example: unpaid licensing fees for spectrum.
  - Pass through government claims.
    Example: is the TDS collected by firms deposited by the RP to government?
  - All government claims in liquidation.

IBC and the CAG: less obvious implications?

- Performance of new institutions born under the IBC have a public sector nature, directly or indirectly:

  Regulator, the *Insolvency and Bankruptcy Board of India*, IBBI.
  Professional agencies, *Insolvency Professional Agencies* , IPAs.
  Information Utilities, IU

- Does the CAG have an audit role in their performance?

  For example, IBBI has a measurement and monitoring role of

  the outcomes of the overall IBC system.
  of economic credit outcomes.

  Is CAG the people's auditor on whether IBBI is carrying out this function effectively?

Thank you

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